

A THEORY OF FINANCIAL AUTHORITY
CREDIT CYCLES AND SOCIAL CONFLICT IN THAILAND AND TAIWAN

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My thesis challenges the central bank independence literature by demonstrating that the delegation of regulatory authority to an independent government agency can lead to asset price inflation and the outbreak of banking crisis. I argue that the central bank independence hypothesis ignores the monetary and fiscal consequences of financial regulation and is therefore conceptually incomplete. Instead of focusing on institutional optimality, I propose that we explain both monetary stability and instability in terms of social inequities generated by regulatory actions.

I develop a game theoretic model that explains the outbreak of banking crisis in terms of strategic conflict between central bank regulators and bank managers. My thesis argues that regulatory actions often generate monetary and fiscal consequences that privilege some members of society and discriminate against others, and thus delegating regulatory authority to an independent central bank may not eliminate the conflict between the interests of bank managers, shareholders and taxpayers.

The substantive chapters of my thesis consist of an empirical investigation of regulatory politics in Thailand and Taiwan. My research is based upon extensive interviews that I conducted at 4 Thai commercial banks, 10 Taiwanese commercial banks. As a result, my research not only offers a new explanation for financial system stability and instability, but uses never before published information in order to reconstruct the decision-making environment of bank managers and financial regulators.

BIOGRAPHICAL SKETCH

Ashraf Mohamed Ismail was born in Egypt. He received his Bachelors of Arts in History at the University of Texas at Austin in 1994, as well as a Masters of Arts in Government from Cornell University in 1997, and a Masters of Science in Economics from the University of Birmingham in the United Kingdom in 1998. Finally, Ashraf defended his Ph.D. dissertation at the Government Department of Cornell University on November 6th 2006, with a focus on international finance, positive political economy and applied game theory.

To my Mother and Father

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LIST OF ABBREVIATIONS

BoA	Bank of Asia
BBC	Bangkok Bank of Commerce
BM	Bank Manager
BoT	Bank of Thailand/Bank of Taiwan
CB	Central Bank
CBC	Central Bank of China
DPP	Democratic People's Party
KMT	Koumantang Party
KTB	Krung Thai Bank
NE	Nash Equilibrium
NPV	Net Present Value
MoF	Ministry of Finance
PLA	People's Liberation Army
PRC	People's Republic of China
TFB	Thai Farmers Bank
TMB	Thai Military Bank
ROC	Republic of China
VAR	Value at Risk

LIST OF SYMBOLS

\$	U.S. dollar
Bt	Thai Baht
\$NT	New Taiwanese dollar
Γ	Lambda; Set of Pure Strategy Nash Equilibrium
λ	Lambda; Lagrangean Multiplier
∂	Gamma; Partial Derivative
\geq	Greater than or equal to
\leq	Less than or equal to
Σ	Algebraic Summation
\exists	Existential Quantifier
\forall	Universal Quantifier

PREFACE

Political Science is obsessed with how things work. The literature is dominated by illustrations of how the legislative committee system stabilizes the U.S. Congress, how international institutions reduce transaction costs and encourage international cooperation, how American leadership promotes global stability, and how institutional delegation enhances democratic government. Rarely if ever, does anyone ask questions regarding why institutions, governments, or regimes fail to work as intended, and when these questions are raised, the failed institutions are inevitably compared to examples of well-functioning institutions, or parties, or regimes that are believed to exist in the United States, Europe or countries that have adopted Euro-American ideas and institutional solutions.

However, we can presume that Euro-American ideas and solutions are superior only if we ignore the many examples of constitutional failure, of mass murder and genocide committed by European nations, and by the United States, in various regions of the world, and only if we ignore the inherent weakness of democratic institutions in the United States, where two similar parties and a handful of interest groups dominate political life, and where various Presidents have waged aggressive war, ostensibly in the name of freedom and democracy, only to bring death and destruction to the regions of the world where freedom was supposed to take root.

Discussions regarding political reality are taboo in political science primarily because white-liberal Americans dominate the discipline, and as a consequence, political science often consists of variations of white-American self-congratulations. In order to transcend the parochialism of political science, I investigate the case when institutional delegation, which is at the heart of modern political science, fails to work as intended. In particular, I investigate the

hypothesis that the delegation of regulatory authority to an independent central bank can lead to financial crisis and economic catastrophe.

My primary insight is that central bank independence is a useful fiction that obscures the distributional realities of financial regulation. I further claim that regulatory systems that distribute the monetary outputs of the banking system iniquitously are more likely to cause debilitating financial crises. The Euro-American system of financial regulation is designed to promote financial innovation, because weakly regulated financial innovation is believed to maximize the rate of economic growth in the long run, even at the cost of recurring and increasingly destabilizing financial crises. And when financial crisis does occur, the historical record suggests that countries that have adopted “central bank independence” engage in massive bailouts designed to minimize the costs imposed upon the bankers who created the crisis in the first instance.

In truth, financial liberalization and innovation induce a period of accelerated monetary growth, which lowers the cost of corporate financing and engenders a sense of economic euphoria among shareholders, but even if we presume that everyone gains from the period of financial expansion, not everyone gains equally, and so the distribution of benefits is central to regulatory policies and financial outcomes. Financially induced recessions also have distributional effects, for they raise unemployment and exclude the most vulnerable members of society from access to financing. The fiscal costs of financial crises can also be distributed regressively, so that minority shareholders and the poorest members of society pay a disproportionate share of the post-crisis rehabilitation costs. And finally, although poorly managed banks are at the heart of every financial crisis, the managers responsible for the crisis often escape accountability. This was true during the S & L crisis of the 1980s, and the same is true in 2008, during which the Federal

Reserve injected billions of dollars of liquidity into the financial system in order to relieve the banks that were most responsible for the credit crisis.

So although the U.S. is not discussed in my thesis, I believe the institutional failure observed in the American financial sector is the result of delegating too much power to the Federal government, to the extent that republican government in the United States has collapsed or will soon collapse irrevocably, if indeed such a principle ever truly existed. If we are to transcend the limitations of political science and Euro-American parochialism, then we must be willing to imagine viable alternatives, and it is my hope that my thesis represents a first step in this direction.

Chapter 1

Introduction

Regulatory Failure and Credit Cycles

1.1 Introduction

Bank failures are at the center of history's greatest economic crises. In 1873 for instance, a banking crisis in Europe caused the largest bank in the United States to collapse, ending the post-Civil War economic recovery. The year 1873 also witnessed the collapse of the Vienna Stock Exchange, which set off a cascade of international bank failures that culminated in the "long depression," of 1873-1896. Bank failures also precipitated or intensified economic crisis in 1893, 1907, the hyperinflation of the inter-war period, and of course; bank failures propagated the great depression throughout the world between 1929 and 1939.¹ The Bretton Woods monetary system dampened, but by no means eliminated bank failures, and between the collapse of Bretton Woods in 1971 and the Asian financial crisis in 1997, there have been 168 balance of payments crises among the developing economies, over half of which were caused by or were concurrent with domestic banking crises.²

Despite the severity of credit-driven economic cycles in recent years, the boom-bust pattern that distinguishes the developing economies is hardly a new phenomenon. As early as 1925, Nikolai Kondratiev observed that the capitalist economies followed a cyclical pattern of development. Building upon this insight, Hyman Minsky proposed that financial fragility and financial crises were inherent properties of capitalist economies, while the neo-Marxist economist Michal Kalecki argued that business cycles and financial instability were politically induced phenomena.³

¹ Kindleberger, Charles, 1994. *Manias, Panics and Crashes: A History of Financial Crises*, (J. Wiley)

² I.M.F. 1998. *World Economic Outlook*. (Washington, D.C.: I.M.F., October). pg. 33

³ Kondratiev, Nikolai, 1935. "The Long Waves in Economic Life," *Review of Economic Statistics*. Nov. 17(6); Minsky, Hyman, 1982. "The Financial-Instability Hypothesis: Capitalist Processes and the Behavior of the Economy", in Charles Kindleberger and Laffargue, eds., *Financial Crises*; (Cambridge University Press); Kalecki, Michal, 1935. "A Macrodynamical Theory of Business Cycles", *Econometrica*

While national systems of financial regulation have evolved far beyond the level that existed when Kondratiev first noticed the boom-bust pattern; the early 21st century is similar to the 1930s in that banking crises have again become so frequent that they threaten the stability of the international financial system. Because of the link between bank failures and wider economic crisis, financial instability has severe welfare implications for the millions of people who must adjust to the deterioration of domestic economic conditions that ultimately follow a systemic crisis. During a financial boom, bankers can amass extraordinary wealth, investors benefit from rising equity prices, workers gain from expanded employment opportunities, and fiscal surpluses can even lead to tax breaks for the average citizen. Following a financial crisis, labor markets contract, and younger workers in particular must adjust to the new reality of diminished prospects, and taxpayers must endure the significant fiscal costs implied by post crisis rehabilitation. Yet despite the clearly observable relationship between social equity and financial stability, as well as the relationship between social *inequity* and financial *instability*, there has been little academic research that investigates the link between social equity and financial dynamics.

Because of welfare effects of bank failures upon society, financial instability and fragility pose several important questions for scholars of international relations and comparative politics. Most notably, banking and currency crises are often preceded by a period of credit expansion, which is then followed by a period of severe recession. This boom-bust pattern is clearly observed among countries that differ in terms of their form of government, and even the degree to which they have undergone financial liberalization and opening. Right wing regimes espousing monetarist theories of economic reform such as Chile prior to the 1982-84 crisis seem just as susceptible to the crippling effects of boom-bust cycles as countries following more heterodox and corporatist policies such as the Mexican PACTO, that was upheld until the 1994 peso crisis.

The Asian and Latin American countries that have experienced boom-bust cycles display a daunting variety of regime types and macroeconomic orientations. In Latin America for instance, credit-induced banking crises are often preceded by periods of rising inflationary pressure and consumption-driven current account deficits, both of which played only minor roles during the pre-crisis period in Asia. Within region and across region comparisons prove similarly puzzling. Thailand, which contained a nascent democracy and had a long tradition of responsible macroeconomic management was just as devastated by financial crisis in 1997 as Indonesia, which had neither a democratic form of government nor as impressive a record of macroeconomic management. The Philippines and S. Korea were also democracies during the 1997 crisis, while Chile was far from democratic during the 1978-82 period of liberalization that also ended in devastating banking and currency crisis. During its bouts of systemic financial crisis, in 1982 and again in 1994, the Mexican political system was more comparable to that of Malaysia or Taiwan in 1997, in that one party still dominated the political life of each country.⁴

According to the Thai economist Ammar Siamwalla, the Asian financial crisis belongs to a “family of crises” wherein high levels of capital inflows, a fixed exchange rate and inadequate regulation and supervision translate into crippling

⁴ Developing economies also display a high degree of diversity in terms of the size and composition of their credit markets. For instance, the total assets managed by the Thai banking sector are roughly the same as Indonesia, and only slightly larger than that of Singapore or Malaysia. Yet in comparison, the diminutive Filipino banking sector does not even reach the size of the single DBS Bank of Singapore. The banking sector of Hong Kong is much larger by regional standards, roughly attaining the size of the Singaporean and Malaysian systems combined. However, one would have to add the banking sectors of Hong Kong, Singapore and Malaysia in order to approach the size of the Taiwanese credit market. And in turn, the Korean banking sector is nearly as large as the combined total of the other four largest regional credit markets.⁴ In terms of composition, regional credit markets range from the highly concentrated banking sector of Singapore (five banks in total) and S. Korea (eight commercial banks), to the much more diffuse Taiwanese credit market which to date contains 43 commercial banks. A cursory analysis of the banking sectors of Latin American countries reveals a similar degree of diversity. The banking sector of Brazil is by far the largest in the region, with Mexico, Argentina and Chile registering at a distant second, third and fourth place respectively. Delhaise, Phillipe. *Asia in Crisis: The Implosion of the Banking and Finance Systems*. (New York: J. Wiley and Sons) pg. 11

balance of payments crisis.⁵ Currency crisis, in turn, serves only to exacerbate insolvency within the financial sector of an afflicted economy. Yet any family resemblance between financial crises in Asia and Latin America is confounded by differences both within each region, as well as across regions, in terms of every other factor imaginable. How then, can we make sense out of the sheer variety of governmental forms and macroeconomic histories among developing countries that have been equally struck by systemic bank failures?

Furthermore, why does there seem to be such a high degree of correlation between banking crisis and balance of payments crisis among the economies of Asia and Latin America? The variation in domestic conditions within countries that experience financial crisis suggest geostrategic shocks; such as unstable capital flows or the threat of military conflict are more likely to be responsible for the recurrence of financial crisis throughout the world?

Regional differences are also reflected in the academic political economy literature. The Asian political economy literature is virtually state-centric, and is primarily concerned with the degree to which ‘state autonomy’ contributed to Asia’s impressive economic development.⁶ Recent arguments challenge the state-centric assumption, but we have yet to fully confront the reality that the theoretical core of the Asian development literature has abruptly collapsed.⁷ In sharp contrast, the Latin

⁵ Interview, Thailand Development and Research Institute (TDRI), September, 2000; see also: Aaron Tornell and Frank Westermann, 2005. *Boom-Bust Cycles and Financial Liberalization*, (Cambridge: M.I.T. Press)

⁶ Wade, Robert. 1993. *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, (Princeton: Princeton University Press). pp. 22; See also: Alice Amsden. 1989.

S. Korea: Asia’s Next Giant. South Korea and Late Industrialization. (New York: Oxford University Press); and Peter Evans. 1995. *Embedded Autonomy: States and Industrial Transformation*. (Princeton: Princeton University Press); Tun-Jen Cheng. 1993. “Guarding the Commanding Heights: The State as Banker in Taiwan,” In Stephan Haggard, et. al., editors: *The Politics of Finance in Developing Countries*, (Ithaca: Cornell University Press); Jung-en Woo. 1991. *Race to the Swift: State and Finance in Korean Industrialization*, (New York: Columbia University Press).

⁷ Robert Wade compares alternative hypotheses to explain state failure including systemic variables as well as domestic firm centered arguments. Others have built upon interest group theories to explain why the Asian economies experienced financial crisis. Robert Wade. 1998. “From

American political economy literature is framed in terms of interest group analysis. Institutional capture by powerful groups, class conflict, or interest group pressure upon policymakers are analytically privileged in order to explain the economic crisis that is so familiar to scholars of Latin America.⁸

Although Asia and Latin America differ in terms of their trading and investment relations, their political organization, and in just about every other way conceivable, the underlying similarity of the two regions in terms of their experience with financial crisis is undeniable. How can regional episodes of banking crisis display so many underlying similarities, yet be explained in terms that are diametrically opposite? The Latin American sociological approach suggests that even in the purportedly state-dominated countries of Asia, close relationships between bankers and public officials can corrupt the regulation and supervision process, leading to a mismanaged financial sector. Yet rarely do interest group theories reveal the reasons why organized political interests can penetrate the policy making process so easily in some countries, while government bureaucracies in other countries seem to be largely impervious to capture by powerful domestic interest groups.

In order to redress these shortcomings, another strand of institutionalism focuses upon the agency problem between the Executive branch of government and the central bank. In this case, the Executive branch may desire banking stability, but the central bank governor conceals any negative information about the health of the banking sector from the country's political leadership.⁹ While this argument provides

'miracle' to 'cronyism': explaining the Great Asian Slump." *Cambridge Journal of Economics*. 22, pp. 693-706; Robert Wade and F. Vernengo. 1998. "The Asian Crisis: the high debt model vs. The Wall Street-Treasury-IMF complex." *New Left Review*, No. 228, (March-April)

⁸ O'Donnell, Guillermo. 1988. *Bureaucratic Authoritarianism: Argentina: 1966-73*, in *Comparative Perspective*. (Berkeley: University of California Press); Stephan Haggard and Robert Kaufman, eds., 1995 *The Political Economy of Democratic Transitions*, (Princeton University Press); Sylvia Maxfield. 1990. *Governing Capital: International Finance and Mexican Politics*. (Ithaca: Cornell University Press); Eduardo Silva. 1996. *The State and Capital in Chile: Business Elites, Technocrats, and Market Economics*. (Boulder: Westview Press).

⁹ Satyanth, Shanker, 2005. *Globalization, Politics, and Financial Turmoil: Asia's Banking Crisis*, (Cambridge University Press)

an explanation for regulatory failure, it presumes that the Executive is naïve and that the central bank is a dictator over the banking sector. Consequently, there is no possibility that bank managers can contradict the regulatory policies announced by the central bank. In other words, the latest form of institutionalism overlooks the relationship between financial regulators and bank managers, which lies at the heart of the financial system. Without insuring that banks will actually adopt the announced regulatory policy however, there is no way to insure the credibility or time-consistency of prudential regulatory standards.

1.2 The Problem of Regulatory Failure

The prevailing explanations for the boom-bust cycles that are observed across the developing economies can be grouped into two categories. Arguments in the first category explain economic outcomes in terms of geo-strategic events, including the occurrence of regional wars and international price or credit shocks. According to the geo-strategic approach, interstate shocks play a similar role to technological innovation or productivity shocks in real business cycle theories.¹⁰ In either case, external shocks or sudden shifts in a country's terms of trade can induce an unstable economic cycle, particularly among export oriented developing economies.

Arguments of the second category are institutionally centered, and explain credit cycles as the result of the central bank's capture by local capitalists, which allegedly contributed to the occurrence of the Asian financial crisis. Recent literature has also applied the political business cycle hypothesis to Latin America, but these

¹⁰ Plosser, Charles. 1989. "Understanding real business cycles." *Journal of Economic Perspectives*, 3, 51-77

Table 1.1: Competing Theories of Boom-Bust Cycles in the Developing Economies

<u>Relevant Actor(s)</u>	<u>Geo-strategic Shocks</u>	<u>Institutional Independence</u>	<u>Distributional Conflict</u>
	Foreign governments or external events	Central bankers and the Executive branch	Regulators and bankers
<u>Casual Logic</u>	Price shocks, credit shocks and inter-state conflict	Bureaucrats behave benevolently or are corrupted by regulatory capture	Financial market outcomes are negotiated between regulators and bankers
<u>Main Prediction</u>	External shocks induce both financial booms and financial crisis	Independent central banks promote monetary stability	Conflict over the allocation of the costs and benefits of financial regulation is endemic
<u>Primary Strength</u>	Emphasizes vulnerability of developing economies to external events	Emphasizes relationship, between executive branch and central bank	Emphasizes distribution of the costs and benefits of regulatory actions
<u>Primary Weakness</u>	Ignores domestic actors and events	Ignores bank management and external events	Excludes external events and subsumes institutional matrix

arguments apply only to democracies and largely ignore financial regulation and the importance of the banking sector for explaining monetary and fiscal outcomes.¹¹

However, my own field research in Thailand and Taiwan, presented in chapters four and five, strongly supports the hypothesis that electoral reform amplifies the effects of credit cycles, both as a result of the governing regime's desire to stimulate the economy prior to an election, and also because banks and other financial institutions are a primary source of campaign financing in most of the developing economies.

To these dominant approaches, I have added a third, which is based upon the theory of distributional conflict. I begin with the premise that financial regulation can produce iniquitous distributions of the monetary and fiscal outputs generated by the banking sector. To clarify the argument, we should distinguish clearly between *inequity* and *inequality*. Inequality, as a matter of principle, is justified in market economies because well-managed banks contribute significantly to economic growth and prosperity, and so bankers may deserve a larger share of the national income than the average worker. Equity, by contrast, implies that every participant in the banking system is afforded their rights and honors their obligations. As a consequence, inequity will arise when financial system participants are denied their rights or fail to honor their obligations.

Hence, a financial outcome is iniquitous if bankers benefit disproportionately from financial expansions, but can avoid responsibility for any misdeeds detected during the expansion phase or following the occurrence of a crisis. Inequity can also arise if post crisis rehabilitation costs are distributed regressively, so that minority shareholders and the poorer members of society are required to pay a disproportionate share of their income in order to bail out the banking system.

¹¹ Alesina, Alberto, 1988. "Macroeconomics and Politics" *NBER Macroeconomics Annuals*. Cambridge MIT Press: 13-52. Hector E. Schamis, "Political Cycles and Exchange-Rate-Based Stabilization" *World Politics* - Volume 56, Number 1, October 2003, pp. 43-78

While some degree of inequality is expected in market economies, iniquitous economic outcomes create incentives for social conflict to emerge over the distribution of the costs and benefits generated by the banking sector, and I hypothesize that conflict over control of the banking system is sufficient to explain the boom-bust cycles that overwhelm so many of the developing economies.

Most theories of political economy focus upon central bank independence, and so presumably, the lack of central bank independence explains the monetary instability from which so many developing countries suffer. However, my own field research in Thailand and Taiwan suggests that external geo-strategic events, and domestic conflict over the control of the banking sector, are far more important for explaining economic outcomes. Furthermore, and as I will argue throughout, institutional arrangements, whether regime type or the formal relationship between the central bank and the Executive branch, are significant for explaining financial market outcomes only when institutional constraints can effectively alter the underlying distribution of costs and benefits created by the financial sector.

The most obvious cross-country institutional distinction with regards to financial governance is the delegation of monetary and regulatory authority to separate institutions in some countries, and to a single institution (the central bank) in other countries. However, Charles Goodhart's exhaustive research regarding institutional separation between monetary policy and banking regulation concludes that institutional separation or unification of monetary and regulatory authority has no measurable effect upon either monetary or regulatory outcomes.¹² Nor are stronger regulations necessarily a panacea, because financial repression can create inefficiencies, such as informal credit markets and loan sharking, which can expand to the point that threaten the stability of the entire economy.

Goodhart, Charles and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision be Separated?" *Oxford Economic Papers*, vol. 47, no. 4 (October 1995), 539-60

Institutional design, no matter how elaborate, is largely irrelevant unless the instruments of monetary and regulatory control can distribute the outputs of the banking system in an equitable manner among the effected sectors of society. This fundamental point remains unrecognized by the political economy literature because institution--centered arguments are obsessed with formal rules and the formal organization of government, but seem largely uninterested in the link between the government and the actual distribution of power within the banking sector or within the broader society. Institution-centered arguments are theoretically sanitized; there is little discussion of coercion, violence, or oppression, and only technical arguments about “credibility” are permitted. But the ultimate effect of regulatory policies upon public welfare, and the political struggles over control of the banking system are conveniently ignored.¹³

Instead, I argue that equity and fairness must be at the center of any discussion of regulatory credibility, primarily because regulatory policies that create social conflict over the distribution of monetary and fiscal outputs of the banking sector undermine the stability of the financial sector and render any consistent government policy unsustainable. Consequently, my findings support the hypothesis that *regulatory or monetary policy trajectories are credible only when they are premised upon an equitable social distribution of the costs and benefits generated by that policy.*

From this perspective, Asian state-centric theories that focus squarely upon the question of bureaucratic independence are simply too blunt of an analytical instrument to comprehend the often subtle dynamics of financial markets.

¹³ Jeffry Frieden’s work focuses explicitly upon the relationship between monetary regimes and the welfare distribution, but he ignores the distributional consequences of financial regulation, as well as the effects of financial regulation upon monetary and fiscal stability. See: Jeffry Frieden, 1994. “Exchange Rate Politics: Contemporary Lessons from American History.” *Review of International Political Economy* 1, no. 1 (Spring); and: Jeffry Frieden, 1997. “The Politics of Exchange Rates.” In *Mexico, 1994: Anatomy of an Emerging Market Crash*, edited by Sebastian Edwards and Moises Naim. (Carnegie Endowment for International Peace).

Table 1.2: The Distribution of the Costs and Benefits of Regulatory Action

	(H 1): <u>Regulatory Prejudice</u>	(H2) <u>Regulatory Failure</u>	(H 3) <u>Regulatory Discipline</u>
I. <u>Actions</u>	Financial Repression	Boom-Bust Cycle	Financial Rehabilitation
Bank Manager Central Bank:	Under-lending Forbearance	Over-lending Forbearance	Over-lending Intervention
II. <u>Economic Outcomes</u>			
Financial System: Exchange Rate:	Deflation Cycle Value Falls and Rises	Boom-Bust Cycle Value Rises and Falls	Monetary Stability Stable Currency
III. <u>Distribution of Costs and Benefits</u>			
Bank Manager: Taxpayers: Shareholders:	Pay Cut Future Surplus Share Values Fall and Rise	Super-Normal Profits Future Deficit Share Values Rise and Fall	Fired Regulatory Cost Compensated

In fact, the state-business relationship that was ostensibly responsible for the high growth rates of the Asian economies until 1997 are the very same relationships that are now being described as “crony capitalism.” Furthermore, state-business theories often assume that the government will always be able to coerce dissident social groups into submission. But the most devastating weakness of state-business interface as an explanation of the Asian financial crisis is that this approach ignores the internal organization of banks, which are viewed simply as “black box” financial intermediaries.¹⁴ At best, banks are conceived to be nothing more than the creatures of powerful business interests, despite the fact that poorly designed systems of internal bank governance are at the heart of every financial crisis.¹⁵ I argue that the legal independence of country’s central bank is in fact epiphenomenal to financial market outcomes, and that further, state-business theories are incapable of encompassing the actual dynamics of financial markets.

However, the same cannot be said about geo-strategic shocks, to which developing countries are particularly vulnerable. For instance, the decade-long recession that afflicted Japan from the early 1990s had a dampening effect upon regional banking systems, and was more significant to the outbreak of the Asian financial crisis than any legal or institutional features of the Asian economies. Furthermore, the financial fallout from the cross-straits crisis between Taiwan and mainland China in 1994-95 destabilized financial markets in Taiwan, and only a massive government bailout kept the crisis from spreading to the real sector of the Taiwanese economy. Consequently, my research strongly suggests that geo-strategic events have profound effects upon the stability of financial systems, because external

¹⁴ Haggard, Stephan, et al. 1997. “Theories of Business and Business-State Relations,” In Sylvia Maxfield and Ben Ross Schneider, editors: *Business and the State in Developing Countries*, (Ithaca: Cornell University Press), pp. 36-60

¹⁵ Matthew I. Saal. 1996. “Internal Governance, Market Discipline, and Regulatory Restraint,” in: *Rethinking Bank Regulation*, proceedings of the 32nd Annual Conference on Bank Structure and Competition, May (Chicago: Federal Reserve Bank of Chicago)

shocks can alter the manner in which costs and benefits are distributed between the managers who govern the region's most important banks, and the taxpayers who must pay the costs associated with bank failures, as well as the bank's shareholders, whose fate is tied to the bank's franchise value.

1.3 Credit Cycles and Social Conflict

My thesis is based upon the premise, which is outlined in Table 1.2, that regulatory actions can induce credit cycles, which thereby create incentives for social conflict to emerge over the monetary and fiscal outputs of the banking sector. During a boom, interest rates fall, making it easier for business and the public to access credit markets. Politicians, whether democratically elected or autocratic rulers can then take credit for the favorable economic conditions. Taxpayers may benefit from lower fiscal deficits or surpluses, and shareholders benefit from higher share prices. In a credit-induced recession, the public and shareholders lose, since a credit crunch reduces access to financing and imposes constraints upon the real sector. Credit-induced recessions also raise unemployment as well as interest rates, but it may be possible for bank managers to benefit from the recession due to their ability to pursue selective credit policies, from which they can extract an economic rent.

So even if we were to assume that everyone may benefit from a boom, and everyone suffers from a bust, this by no means implies that everyone benefits or suffers equally. During a boom, bank managers can make super-normal profits, while in a bust, bank managers can often successfully shift the costs created by their irresponsible behavior to taxpayers and to minority shareholders, who are then left with the cost of cleaning up the crisis. Financial liberalization can also prove a bonanza for political parties who can then more easily finance political campaigns, using both legal and illegal means to do so. This phenomenon was particularly

pronounced in Thailand and Taiwan's provincial and legislative elections. Financial repression, by contrast, is bad for depositors but maybe good for bureaucrats because a repressed financial market can fund military spending and large-scale development projects.

These features of a financial cycle are inexplicable from the viewpoint of institutional arguments, which focus instead focus upon the political independence of the central bank and the autonomy regulatory agencies. While superficially attractive, the central bank independence hypothesis ignores the realities of banking in the developing economies. The Bank of Thailand for instance contains a large number of officials who were awarded economics PhDs from the many of the world's most respected academic institutions. Hence, whatever the Bank of Thailand's problems, the intellectual competence of its technical staff is not in question. Officials at Taiwan's Central Bank of China and its Bureau of Monetary Affairs, by contrast, give the outside observer an impression that Taiwanese regulators approach their profession with a discipline and determination that is comparable to a military organization, and it is not an exaggeration to state that financial regulation in Taiwan is a question of national survival.

Rather than explain outcomes in terms of government type or sociological relationships between government and business, I will instead analyze outcomes in terms of the incentives that underlie each country's regulatory apparatus and the strategic decisions of both bankers and bureaucrats. I will proceed by reconstructing the decision-making environment of regulators and bank managers, and then by analyzing how each actor responds to challenges posed by the dynamics of their respective strategic environments. The decision-making environment within which both banks and regulatory agencies operate is normally ignored by theories of financial politics, but as I shall argue systematically throughout, such an analysis opens up previously unexplored dimensions of bureaucratic politics.

The fit between government regulations and the actual management of banks can be described as a contract, through which the regulatory agencies govern the credit market by specifying the responsibilities and privileges of both bank managers and public regulators. The contract metaphor is also useful because it makes possible the distinction between bargaining over the substance of the contract and bargaining over the enforcement of a contract that has been successfully negotiated between bankers and regulators. For instance, through legislative institutions, electoral politics can affect the substance of the regulatory agreement, but electoral politics can also affect the extent to which each party will fulfill their contractual obligations.

The contract-theoretic approach is also sufficiently general to encompass similar regulatory problems in non-democratic systems. Within autocracies, or governments that are in a transitional phase, effective regulation can be weakened by an expansion of the decision making process to include representatives of the banking community. Regulatory credibility and prudence can also be compromised by the desire of public authorities to promote their respective financial sectors internationally, which thereby create a potential conflict of interest between the logic of political expediency and the demands of prudent financial regulation. In either case, regulatory action or inaction can induce a credit driven cycle that alters the social distribution of the monetary and fiscal outputs of the banking sector.

1.4 Dissertation Outline

My thesis challenges the central bank independence literature by presenting evidence that the delegation of regulatory authority to an independent central bank can lead to the outbreak of banking crisis. I argue that the central bank independence hypothesis ignores the monetary and fiscal consequences of financial regulation and thus is at best conceptually incomplete. Instead of focusing on institutional

optimality, I propose that we explain both monetary stability and instability as a result of the underlying social conflict over the distribution of the costs and benefits of financial regulation.

In chapter two, I develop a perfect information non-cooperative model that explores the relationship between social equity and financial stability, and that further explains financial system outcomes in terms of strategic conflict between central bank regulators and bank managers. I hypothesize that every regulatory action generates monetary and fiscal consequences that privilege some members of society and discriminate against others, and thus, distributional conflict is endemic to financial regulation and cannot be eliminated by delegating regulatory authority to an independent central bank.

I begin by assuming that the executive branch delegates regulatory authority to an independent central bank. The central bank regulates the financial sector, which is composed of a single bank, whose balance sheet decisions are fully observed by the central bank. I then find that for a range of parameter values, there exists a set of pure strategy Nash equilibria that support the hypothesis that social conflict is endemic to financial regulation and cannot be easily eliminated by institutional delegation.

Employing the contract theory paradigm, I generate three conceptual categories: *regulatory failure*, *regulatory discipline* and *regulatory prejudice*, which can then be used to analyze the spectrum of crisis and non-crisis countries, and which illustrate how the monetary and fiscal costs and benefits generated by the banking sector can be re-distributed by regulatory action. For convenience, I have divided society into three relevant categories; bank managers, taxpayers, and minority shareholders, among whom regulatory officials through their action or inaction distribute the monetary and fiscal outputs of the banking sector. Ultimately, the purpose of employing game-theoretic techniques is to reduce the relationship between

the posited variables and observed outcomes to manageable theoretical proportions, and to generate specific and testable hypotheses.

Chapter three discusses the exogenous factors, such as a country's external environment and the corporate organization of the banking sector, that impinge upon the internal dynamics of the model, and thereby provides a conceptual bridge between the theoretical chapter and the empirical chapters. Chapters four and five consist of empirical investigations of regulatory politics in Thailand and Taiwan. My research not only offers a new explanation for financial system stability and instability, but uses never before published information to reconstruct the decision-making environment of bank managers and financial regulators.

As a result of extensive interviews that I conducted at 6 Thai commercial banks, and 10 Taiwanese commercial banks as well as each country's monetary and regulatory authorities, I have focused my case studies upon the distribution of regulatory costs and benefits between three social groups: taxpayers, bank owners, and minority shareholders. The two case study chapters are also the result of internal surveys and interviews conducted at various departments of the Bank of Thailand, the Central Bank of China, and the other government agencies responsible for regulation and supervision in Thailand and Taiwan.¹⁶

Thailand experienced an extended period of financial system stability during the 1950s-60s, that minimized the need for taxpayer sponsored bail outs, but came at

¹⁶ Bank of Thailand: Legal Dept., Monetary Policy Division, Economic Research Dept., Supervision Policy Dept., Bank Examination Dept., and Human Resources Dept.; Ministry of Finance: Legal Dept., Special Committee on Financial Policy; Thailand Stock Exchange Listing Department, Market Surveillance Dept.; Financial Sector Restructuring Authority; Asset Management Corporation; Thailand Institute for Research and Development; Office of the President, Financial Policy Division.

Central Bank of China: Legal Dept., Monetary Policy Dept. (Banking Dept.), Economic Research Division, Personnel Dept., Bank Examination Dept., Foreign Exchange Dept.; Ministry of Finance: Bureau of Monetary Affairs, Bank Examination Dept.; Central Depository Insurance Corporation: Financial Distress and Rehabilitation Division, Bank Examination Division; Taiwan Stock Exchange: Listing Dept.; Market Surveillance Dept.; Executive Yuan: Office of the Prime Minister, Committee for Economic Planning and Development.

a cost of military control of the banking system that stifled financial innovation and growth. During the 1980s and 1990s by contrast, Thai commercial banks reconfigured their internal organization to take advantage of the period of financial liberalization. The transformation of Thai bank management helped initiate the boom of the 1990s, but came at a cost of large-scale fraud within the banking system that precipitated the financial crisis of 1997 and was ultimately paid for by taxpayers and the poorest members of Thai society.

Because of Taiwan's precarious geo-strategic position, the government initially resolved the conflict between taxpayers, bank managers and shareholders by forbidding private ownership of banks and by imposing severe limitations upon bank managers. However, financial system stability was threatened during the 1990s by financial liberalization, the fallout of the cross-straits diplomatic crisis, the regulatory consequences of electoral fraud and vote buying, as well as the macroeconomic deterioration that followed the Asian financial crisis. To maintain control over bank managers, Taiwan has had to engage in constant and pre-emptive institutional innovation, and following the ascent of the Democratic People's Party (DPP) to power in 1999, Taiwan initiated a large-scale purge of the financial system from corrupt bank managers who were associated with the previous regime. Chapter six consists of a discussion of the weaknesses inherent in my approach as well as suggestions about how to improve my model and test its predictions empirically.

Chapter 2

Financial Authority

A Contract-Theoretic Interpretation

2.1 Introduction

The dominant school of political economy presumes that a government can make a credible commitment to monetary stability by delegating control of monetary policy to an independent central bank. According to this scenario, the independent central bank would then select a rate of inflation that maximizes social welfare. Monetary stability is assured by tying the inflation-prone hands of politicians with a politically neutral and independent central bank, which thereby acts as a binding mechanism. However, the banking sector, which is arguably the main source of monetary and fiscal instability in the developing countries, is left out of this picture.

Once the banking sector is incorporated theoretically into the institutional delegation argument, it becomes evident that institutional delegation can produce a range of macro-outcomes, including outcomes that imply an iniquitous distribution of monetary and fiscal costs and benefits, which will inevitably undermine the stability of the banking sector by leading to episodes of asset price inflation/deflation and systemic banking crisis. The regulatory channel of monetary policy thus provides a new perspective for understanding the sources of inflation and deflation, as well as the distributional consequences of financial regulation more broadly. In summation, I argue that the central bank independence hypothesis can only provide an incomplete causal explanation for inflation or deflation, and is further *incapable* of explaining the type of system-wide banking crisis that has become so commonplace among the developing economies.

I develop a formal model that challenges the central bank independence literature by explaining inflation as well as deflation in terms of a strategic bargaining process between central bank regulators and domestic bank managers. My model also goes beyond the central bank independence literature by explaining the outbreak of banking crisis in terms of social iniquities, which lead to strategic conflict between

the different sectors of society, over the distribution of the costs and benefits of financial regulation. Conflict between the sectors of society is institutionalized in terms of a *regulatory contract* that is negotiated between bank managers and public regulators, on behalf of the bank's minority shareholders and on behalf of the taxpayers respectively. The purpose of the regulatory contract is to distribute the costs and benefits of financial regulation equitably among the members of society. My primary finding is that because every regulatory action generates monetary and fiscal consequences that privilege some members of society and discriminate against others, distributional conflict is endemic to financial regulation and cannot be eliminated by delegating regulatory authority to an independent government agency.

Methodologically, I argue that contract theory provides a superior analytical framework for explaining the distributional conflicts that are inherent to financial regulation. Instead of viewing the outbreak of banking crisis retrospectively, as causally over-determined by macroeconomic conditions or institutional corruption, I have developed a new theoretical device, the *regulatory contract*, that explains monetary and fiscal outcomes in terms of a set of forward looking decisions regarding the inter-temporal distribution of the costs and benefits of financial regulation. Unlike the central bank independence hypothesis, which explains monetary outcomes in terms of the central bank's tolerance for inflation, the contract theoretic approach to financial regulation acknowledges the possibility that bank managers can contradict the central bank's announced policy, and so even an independent central bank may be forced to negotiate an inter-temporal trade-off between current output and future debt. The determination of monetary outcomes according to the central bank independence hypothesis is compared to the regulatory channel of monetary policy in Figure 2.1 below.

Central Bank Independence Hypothesis

Executive delegates monetary authority to an independent central bank



Central bank selects inflation-unemployment level



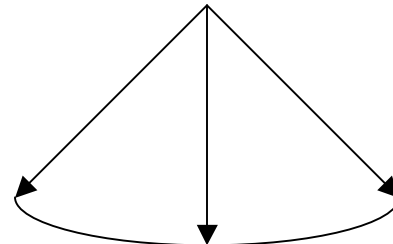
Inflation level is realized

Distributional Conflict Hypothesis

Executive delegates regulatory authority to independent central bank



Central bank negotiates monetary outcome with bank managers



Boom-Bust Cycle

Monetary Stability

Deflation Cycle

Figure 2.1 An Alternative Approach to Monetary Outcomes

Following the logic of the delegation hypothesis, I begin by assuming that the executive branch of government delegates regulatory authority to an independent central bank. However, as is illustrated in Figure 2.1, I then proceed to demonstrate that a range of monetary and fiscal outcomes is possible given this institutional set-up, including the possibility of regulatory failure and the outbreak of system-wide banking crisis. In order to overcome the deficiencies of current theories of institutional delegation, I propose that we conceive of macro-outcomes, which include both instances of monetary stability as well as cases of monetary *instability*, as the result of a contractual negotiation between the central bank and the bank manager over the distribution of the costs and benefits of financial regulation.

According to this scenario, political constituents would then lobby the public regulator to adopt the policy that is favored by the constituents, with the

understanding that any action taken by the regulator would result in fiscal and monetary externalities for the remaining members of society. If the resulting distribution is iniquitous, then inter-temporal conflict over the distribution of the monetary and fiscal externalities of the banking sector becomes inevitable, because iniquitous regulatory actions privilege some members of society and discriminate against others.

The substance of the contract consists of a complete specification of the inter-temporal distribution of monetary and fiscal consequences of each regulatory action. According to the terms of the regulatory contract, monetary acceleration in the current period is paid for by the accumulation of debt, which must be paid at a future date, and thus, while the government will benefit from presiding over a booming economy, the monetary expansion comes at a cost of future debt that must be borne by taxpayers. By contrast, a monetary contraction, that must often be endured in order to stabilize an economy, reduces the rate of monetary expansion, but benefits taxpayers by lowering the rate of debt accumulation, thereby generating a fiscal windfall at a future date.

Monetary expansion and contractions will also impinge upon the utility of bank managers and bank shareholders, whose profit margins and returns will expand or contract in proportion to the prevailing monetary conditions. As a consequence, the purpose of the regulatory contract is to inter-temporally distribute the monetary and fiscal consequences of regulatory actions equitably among the members of society.

The model predicts that the bank manager will obey the government's prescribed regulatory standards (i.e. bank capital requirements will be binding) only if the manager is certain that failure to do so would result in corrective regulatory action. The model also predicts that the threat to intervene will insure compliance, if and only if, the post-crisis bankruptcy resolution process forces the bank manager to

bear the costs of financial rehabilitation as well as personal liability for any wrongdoing. Moreover, the model predicts that at the macro-level, the central bank will tolerate poorly managed banks in order to accelerate the rate of monetary expansion, which allows the government to selectively allocate credit to its political constituents, and which would also benefit the delinquent bank manager, who earns super-normal profits. However, the expansionary credit policy generates a future cost to the public treasury (i.e. for the taxpayers) and to the bank's minority shareholders, who must absorb the costs that result from the eventual failure of the poorly managed bank. Most significantly however, the model demonstrates that the distributional conflicts that surround financial regulation are endemic, and thus, there is no ideal institutional design or political configuration that can fully resolve the policy dilemmas that are implied by the model. Instead, regulators confront a set of trade-offs between the current and future consequences of regulatory action, and thus, rather than maximizing social welfare, an independent central bank can only achieve a set of second-best outcomes.

The intractability of the institutional design problem raises a potentially devastating theoretical criticism for arguments predicated upon the conceptual significance of central bank independence, as well as for other institutional solutions that imply Pareto optimality, but ignore social equity (the monetary and fiscal consequences of regulatory policy).¹⁷

In accordance with the 'credit view' of monetary policy, the model assumes that the credit allocation decisions of banks have a distinct and independent effect upon overall economic output.¹⁸ Consequently, at the macro level, the public regulator may face a trade-off between the monetary benefits of accelerating the rate

¹⁷ The relationship between banking regulation and monetary policy is a largely unexplored region of economic theory. See: Blum, J. and M. Hellwig, "The Macroeconomic Implications of Capital Adequacy Requirements for Banks," *European Economic Review*, 39 (3-4), 739-49

¹⁸ For a theoretical assessment of the credit view of monetary policy, see: Walsh, Carl E., *Monetary Theory and Policy*, Second Edition, (Cambridge, MA: MIT Press, 2001), Chapter 7

of credit expansion and the regulatory costs of tolerating poorly managed banks. The potential conflict between the government's monetary commitments and its regulatory obligations suggests that the notion of institutional optimality presumed by the central bank independence literature is conceptually incomplete. More generally, if regulatory policy is fully delegated to an independent agency or central bank, the regulatory trajectory adopted by the central bank will generate monetary and fiscal incentives for distributional conflict to emerge between the different sectors of society.

The model simplifies society into three sectors, which are: (i) the bank manager, (iii) the taxpayers, and (iv) the bank's minority shareholders. The model's results support the hypothesis that each regulatory action generates costs and benefits that must be distributed among the various sectors of society, and therefore, social conflict can emerge between the members of society over the consequences of regulatory action.

The model begins with a stylized description of the internal organization of a bank, in terms of the rights and obligations of the bank manager as well as those of the bank's minority shareholders. Although minority shareholders take no further action beyond delegating decision making authority to the bank manager, the decisions of the bank manager have a direct impact upon the welfare of the bank's shareholders, which creates a potential conflict between the interests of the bank manager and those of the minority shareholders. The bank manager's decisions also affect taxpayers and the government, who are represented in the model by the public regulator.

Constitutionally, we can assume that the central bank is granted authority over the banking system, which is populated by the single bank, in order to maintain a constant rate of monetary expansion under regulatory constraints that preserve the solvency of the banking system. However, the government may also make a

commitment to provide its political allies and clients with easy access to credit, which is represented in the model as an acceleration of the rate of credit expansion. The relaxation of the credit constraint would thus enrich the government's political constituents, but would also directly contradict the central bank's constitutionally mandated prudential obligations. In summation, the model represents the conflict of interest between the bank manager and the bank's minority shareholders, and also incorporates the potential conflict between the bank manager and the central bank over the macro-consequences of the bank manager's credit allocation decisions. If we assume that the bank manager's credit allocation decisions are common knowledge, then the solution of this simple model of financial authority would require the derivation of the parameter values under which the regulatory contract is incentive compatible.

The solution proceeds first by identifying all strategy profiles that satisfy the Kuhn-Tucker conditions. Strategy profiles that satisfy the Kuhn-Tucker conditions form 'candidate solutions' that are locally optimal. The global optimality of any candidate solution is guaranteed by comparing the utility derived from the candidate solution to all pure strategy permutations of the game. Employing the Kuhn-Tucker conditions and global optimality procedure, we can identify all pure strategy Nash equilibria that satisfy the terms of the regulatory contract as well as Nash equilibria that entail strategies (adopted by either the bank manager or the central bank) that are in violation of the terms of the regulatory contract.

The social distribution of the consequences of regulatory actions is illustrated in Table 2.2 below. The distribution of Nash equilibria can then be used to construct a comparative statics framework. For theoretical purposes, I have divided the set of equilibrium strategy profiles into three categories: (i) an equilibrium that satisfies the conditions of the regulatory contract, (ii) an equilibrium that represents unwarranted

Table 2.1: The Distribution of Monetary and Fiscal Consequences of Regulatory Action

<u>Bank Manager's Strategy</u>	<u>Action</u>	<u>RegulatoryEconomic Outcome</u>	<u>Tax payers</u>	<u>Bank Manager</u>	<u>Shareholders</u>
(1) Bankrupt	Forbear	Boom-Bust Cycle	Future Deficit	Rich	Poorly capitalized
(2) Bankrupt	Intervene	Monetary Stability	Regulatory Cost	Fired	Compensated
(3) Solvent	Forbear	Monetary Stability	Possible Deficit	Keeps Job	No change
4) Solvent	Forbear	Monetary Stability	Balanced Budget	Keeps Job	No Change
(5) Wealthy	Intervene	Monetary Stability	Regulatory Cost	Fired	Compensated
(6) Wealthy	Forbear	Deflation Cycle	Future Surplus	Pay Cut	Well-capitalized

forbearance, and (iii) an equilibrium that represents regulatory intervention, which can be interpreted as prompt and corrective action.

The solution to the regulatory contract generates six pure-strategy Nash equilibrium sets which I have interpreted in terms of the bank manager's behavior, the central bank's regulatory response, and finally, in terms of the ultimate distribution of the costs and benefits of the government's regulatory actions. Conceptually, and in accordance with Table 2.2, I have organized the model's solution into three substantive categories.

(I) *Regulatory failure* is represented by scenario (1), and describes the trade-off between monetary acceleration in the current period and the future debt that must be borne by taxpayers as a result of accelerated monetary growth. Scenario (1) can therefore explain the conditions under which regulatory inaction can precipitate a banking crisis.

(II) *Regulatory discipline* is represented by scenarios (2) – (5), and analyzes the parameter values under which the bank manager's credit allocation decisions obey the terms of the prudential regulatory contract. Scenarios (3) and (4) fulfill the bank manager's contractual obligations, and also Pareto dominate the intervention scenarios, (2) and (5), which demonstrates that the regulatory contract is incentive compatible.

(III) *Regulatory prejudice* is represented by scenario (6), and describes the distribution of the costs and benefits of monetary deflation. The internal content of each regulatory scenario can then be analyzed in terms of bank management strategy, the overall macro consequences, and the post-crisis distribution of bankruptcy costs and executive control rights. Finally, the solution to the model allows for a precise analysis of the inter-temporal distribution of the monetary and fiscal consequences of regulation actions, including the pre-crisis enforcement of prudential standards, as well as the conflicts that also arise during the post-crisis allocation of bankruptcy costs and executive control rights. The final interpretive section of the essay, analyzes the

conceptual significance of the inter-temporal trade-offs implied by the model for the institutional delegation hypothesis.

2.2 The Model

The architectural design of a country's regulatory system can be modeled as a contractual relationship between the central bank (CB), who is the principal, and the bank manager (BM), who adopts the role of the agent. Within the contract theoretic paradigm, a set of constrained optima can be obtained by maximizing the utility of the principal while the utility of the agent is held to a given utility level. So if we are interested in common properties of the optima and not in one particular optimum, this approach brings no loss of generality.

Part one presents a simple decision-theoretic representation of the bank manager's credit allocation decisions. The bank manager's credit allocation decisions are analyzed; first in a permissive regulatory environment and then in an environment of regulatory activism. In part two, the powers of the central bank are defined by a regulatory contract, in which the rights and obligations of both the central bank and the bank manager are specified. Finally, in part three, the results generated by the model are interpreted within a generalized comparative statics framework, which provides a complete specification of the endogenous parameters that can explain the causes of regulatory success as well as the underlying reasons of regulatory failure.

2.21 Governing Banks

Section one presents a stylized decision-theoretic representation of the bank manager's credit allocation decisions upon which the entire model is founded. Bank governance is defined in terms of the bank manager's two most important management

decisions; which are decisions regarding credit expansion (loan approval), and decisions concerning the appropriate level of the bank's capital reserves. By assumption, the BM's goal is to maximize personal income, which is a linear function of the BM's asset and capitalization decisions. From the perspective of the BM, the bank's optimal balance-sheet decisions are dependent upon the prevailing regulatory environment; or more precisely, on whether the bank manager faces a regulator that is predisposed towards forbearance or intervention.

The intuition behind the model is simple. The bank is composed of a group of shareholders, who delegate all management decisions to the BM. The BM extends a loan, $a = \{a_i\}$; which enters into the BM's financial statement as an asset, and which is illustrated in Table 2.1 below. The BM then raises a level of loan loss reserves, $k = \{k_j\}$, which is meant to cushion the bank from the possible failure of the loan. The BM's actions can be stated formally as; $BM = \{a_i, k_j\}$, $i = 0, 1$ and $j = 0, 1$. By assumption, there are two types of assets; a_1 = a high quality asset and a_0 = a low quality asset, which yield a discounted present value for the bank of: $a_1 \geq 0 > a_0$, respectively. Also by assumption, there are two levels of loan loss reserves; k_0 = a low level of reserves, and k_1 = a high level of reserves, and so: $k_1 > k_0 \geq 0$. Since reserves are scarce, each reserve level, k_j , is associated with a corresponding cost c_j which can be stated as, $c_1 > c_0 > 0$.

The bank's balance sheet is composed of two components: assets and liabilities, which by construction, must equal to zero. The bank's liabilities consist of deposits accepted by the bank as well as the bank's equity capital. By contrast, the bank's asset balance, $(a_i + k_j)$, is composed of the discounted present value of the loans extended by the bank a_i , as well as the bank's reserves, k_j . Loan loss reserves are defined actuarially as provisions that are set aside by the bank's management in order to offset any losses caused by failed loans. Hence, if we assume that there is no exogenous variation in the

bank's liabilities, then the bank's asset balance, $(a_i + k_j)$, will determine any change in the bank's net worth.¹⁹

Each asset type also generates a revenue stream for the BM. Asset type a_l represents a loan to a viable firm or a well-managed investment project that yields a return to the BM of G_l . By way of contrast, assume that a_0 represents a loan that becomes non-performing and must then be listed as a loss on the bank's balance sheet. However, if we further assume that a_0 is a self-loan (i.e. a loan from the bank to the bank manager), or that a_0 represents a loan to a related firm, then even if the bank is never repaid, the BM personally gains G_0 . The parameter G_0 can therefore be interpreted as the benefit obtained by the BM from a "relationship loan," and if we assume that $G_0 > G_l > 0$, then the BM has an obvious incentive to extend a loan to a related firm or to engage in a self-loan.

Assume however, that as the bank's chief executive officer, the BM is obligated to personally assume the cost, c_j , of raising loan loss reserves, k_j , and so the BM's actions are not wholly unconstrained. Hence, the BM personally gains an income, $G_i - c_j$, for governing the bank; and the BM's management decisions further alter the bank's net worth by $(a_i + k_j)$, which is then distributed as dividends among the bank's minority shareholders. By assumption, $(a_i + k_j)$ enters into the BM's utility in order to capture the BM's fiduciary responsibility to protect the interests of the bank's shareholders. However, should the BM choose to behave opportunistically and select $\{a_0, k_0\}$, then without any outside liquidity support or regulatory intervention, the minority shareholders would be forced to absorb the resulting deficit in the bank's net worth.

¹⁹ William D. Miller, *Commercial Bank Valuation*, (New York: J. Wiley and Sons, 1995), 100, 108, 117, 119, 134-35; Oliver G. Good and Robert J. Porter, *Analysis of Bank Financial Statements*, (New York: Van Nostrand Reinhold Co., 1979), 13. The provision for loan losses is a reserve account held by the bank in order to cover unanticipated losses on loans and leases. The provision for loan losses is an expense item, in that it is treated as a charge against the bank's current income. Hence, loan loss expenses are subtracted from the income generated by the bank's asset portfolio, and furthermore, any subsequent actual loan loss that is experienced by the bank will be applied against the loan loss reserve. Consequently, the bank's loan portfolio, net the bank's loan loss reserve, yields the net asset balance.

Finally, we will assume that any variation of the bank's net worth is determined in a non-stochastic manner, and so the management decisions that leave the bank undercapitalized, overcapitalized or optimally capitalized are common knowledge:

Table 2.2: Bank Manager's Financial Statement

<u>Manager's Income</u>	<u>Asset Value</u>	<u>Loan Loss Reserves</u>	<u>Δ in Bank's Net Worth</u>	<u>Regulatory Status</u>
$G_0 - c_0$	a_0	k_0	$(a_0 + k_0) < 0$	Bankrupt
$G_0 - c_1$	a_0	k_1	$(a_0 + k_1) \leq 0$	Optimal Capitalization
$G_1 - c_0$	a_1	k_0	$(a_1 + k_0) \geq 0$	Optimal Capitalization
$G_1 - c_1$	a_1	k_1	$(a_1 + k_1) > 0$	Wealthy

The CB is constitutionally invested with financial authority in order to maintain a constant rate of credit expansion while safeguarding the solvency of the financial sector. Legally, the CB should therefore prefer that the BM select either $(a_0 + k_1)$, or $(a_1 + k_0)$; both of which expand the credit supply at a constant rate, and as indicated above, do so under regulatory constraints that leave the banking sector adequately capitalized.²⁰

²⁰ In case of a deficit in the asset balance, $(a_i + k_j) \leq 0$, the deficit must be covered by the bank's equity capital, which is held by the bank's shareholders and which would reduce the level of the bank's capitalization. In contrast, a asset balance surplus, $(a_i + k_j) \geq 0$, could be treated as retained earnings and subordinated into the bank's Tier-2 capital, which accords with BIS procedures regarding loan loss reserves. See: Miller, *Commercial Bank Valuation*, 100

2.21 (A) Optimality Conditions

Assuming that the BM accepts the government's regulatory standards, optimal capital-asset decisions must fulfill two sets of conditions:

- (i) The Kuhn-Tucker conditions, and
- (ii) The incentive compatibility constraint.

i) Kuhn-Tucker conditions:

The BM's utility function may be represented as:

$$U_{BM}(a, k) = U(G_i - c_j + (a_i + k_j)) \quad (2.2)$$

The BM's utility function is additively separable in the components; revenue G_i , cost of capital c , and net capital-asset position $(a_i + k_j)$. The assumption that the BMs preferences are described as an additively separable function implies that risk neutrality does not vary with the asset type and level of capital reserves selected by the BM. The BM's utility function is assumed to be weakly concave in its arguments and the BM's marginal disutility increases with a higher cost of reserves, which can be stated formally:

$$U_{BM}'(\cdot) > 0, U_{BM}''(\cdot) \leq 0$$

ii) Incentive Compatibility Constraint

The incentive compatibility constraints require that the BM will prefer the capital/asset combination that is also preferred by the CB. The BM should therefore self-select the appropriate level of capital as defined by the CB's statutory pronouncement.

$$U_{BM} (G_0 - c_1 + (a_0 + k_1)) \geq U_{BM} (G_0 - c_0 + (a_0 + k_0)) \quad (2.31)$$

$$U_{BM} (G_1 - c_0 + (a_1 + k_0)) \geq U_{BM} (G_1 - c_1 + (a_1 + k_1)) \quad (2.32)$$

The incentive compatibility conditions do not hold simultaneously, because the BM can select only one set of asset-reserves combinations. Hence, equation 2.31 corresponds to $\{a_0, k_1\}$, and equation 2.32 corresponds to $\{a_1, k_0\}$. For now, we are only considering the BM's management decisions in isolation, but in section 2.2 we will re-state the entire optimization problem in a much more general manner.

2.21 (B) Regulatory Action

Regulatory action refers to the consequences of the central bank's decision to intervene, as well as the consequences of the government's decision to practice forbearance. Regulatory action can have three distinct effects upon the BM's utility, (i) The allocation of executive control rights, (ii) The distribution of bankruptcy costs, (iii) Lender of last resort effects.

(i) The Lender of Last Resort

The CB is legally bound to provide lender of last resort facilities to the bank that selects $\{a_0\}$, by absorbing any balance sheet deficit (i.e. when $(a_i + k_j) \leq 0$). However, the CB's legal obligation applies only if the BM selects an optimal capitalization level $\{a_0, k_1\}$. Hence, if the BM selects $\{a_0, k_0\}$, the CB is granted the power to adjust the banks' capital level to $\{a_0, k_1\}$, in accordance with prudential regulatory standards. Note that intervention imposes a "double indemnity" of revenue seizure and balance sheet correction.

(ii) The Social Distribution of Bankruptcy Costs

The social distribution of bankruptcy costs between the bank manager and taxpayers is determined formally by balance sheet corrections that are made following intervention. By assumption, the CB will correct any balance sheet under-capitalization $(a_0 + k_0)$ or overcapitalization $(a_1 + k_1)$, by forcing the BM to adopt an optimal loan loss reserve level; $(a_0 + k_1)$ and $(a_1 + k_0)$, respectively. In the case of under-capitalization, the CB's balance sheet correction represents a shifting of the burden of post-crisis bankruptcy costs upon the delinquent bank manager.

(iii) The Allocation of Executive Control Rights

The most direct way for the CB to affect the bank manager's utility is for the CB to seize the BM's revenue and to redistribute the bank's revenue to the minority shareholders, which can be interpreted as the loss of the BM's executive control rights over the bank's future decisions, or as the removal of the BM from their executive

position.²¹ In section 2.21, we assumed that the bank's minority shareholders must absorb any balance sheet deficits, which translates into an erosion of the bank's equity base, thereby causing bankruptcy. Hence, if the CB intervenes in a bank that is undercapitalized ($a_0 + k_0$), or overcapitalized ($a_1 + k_1$), then the CB will seize the entirety of the BM's revenue stream, G_i , and will redistribute a fraction of that revenue, v_{ii} , to the bank's minority shareholders. By assumption, v_{ii} enters into the BM's utility in order to represent the manager's fiduciary responsibility to the minority shareholders, and so the portion of revenue that remains following intervention can be represented as $G_i - v_{ii} \geq 0$. Thus, if the entirety of the BM's revenue is redistributed to minority parties, then $G_i = v_{ii}$.

2.22 The Regulatory Contract

Section two explores the consequences of delegating authority over financial regulation to an independent public regulator. Assuming that the regulator can observe the bank manager's capital-asset decisions, the public regulator must then decide whether to engage in a costly intervention in the bank's operations. As previously stated, the purpose of the regulatory contract is to publicly specify the balance sheet conditions under which the CB will practice forbearance, as well as the conditions under which the PR will intervene in a bank's operations. Therefore, the central bank must balance the costs and benefits of intervention against the costs and potential benefits of adopting a lenient regulatory attitude. Constitutionally, the central bank's

²¹ Dewatripont, M., and J. Tirole, *The Prudential Regulation of Banks*, (Cambridge: MIT Press, 1994), 31-35. The "representation hypothesis" applies only to the protection of depositors, who are especially vulnerable because their interests are diffused and because depositors are un-represented on the bank's board of directors. However, if the bank manager is also the majority shareholder, as is the case with commercial banks in the developing economies, then failure would hurt the interests of the minority shareholders as well as depositors. Furthermore, since the bank's equity is subordinate to the bank's deposits, the interests of minority shareholders are also vulnerable to financial mismanagement.

primary responsibility is to enforce the government's statutory limitations upon bank governance. Hence, the regulatory contract is written in a manner that fully specifies the capital-asset combinations that fulfill the government's publicly announced goal; which is a constant rate of credit expansion under regulatory constraints that preserve the stability of the financial sector.

Within the legal environment created by the regulatory contracts, forbearance is deemed unwarranted when the CB refuses to intervene in a BM's activities despite evidence of sub-optimal bank governance decisions. However, the public cost of regulatory activism is an interruption of the credit supply, and thus intervention would be especially costly if public authorities interfere unnecessarily with the management of a solvent financial institution. An interruption of the credit supply could conflict directly with a government's wider political goals, such as the coherence of a parliamentary coalition or the consolidation of an authoritarian ruler's relationship with their political clients. Consequently, the trade-off between banking regulation and a government's credit commitments may be an unavoidable political reality that can prove decisive for a government's hold on power.

Because taxpayers must absorb the costs of unwarranted regulatory lenience, the government's regulatory decisions have several distinct implications for the social distribution of bankruptcy costs. Regulatory intervention may be the only way to force the bank manager to bear responsibility for the ultimate social costs of their management decisions. Otherwise, in the case of unwarranted forbearance, the bank manager can gain privately from violating prudential standards, while the public must pay the cost of the bank manager's malfeasance. The final sub-section of the regulatory contract publicly announces the consequences of regulatory intervention for the bank's executive board members. According to the terms of the regulatory contract, should the bank manager violate the government's regulatory statutes, the manager's revenue

share will be seized by the regulator and re-distributed to the bank's minority shareholders, thereby terminating the manager's executive position.

The description of the contract theoretic model proceeds first by outlining the timing of each actor's moves, and then by fully specifying the terms of the regulatory contract. The extensive-form of the contractual relationship is presented, and employing the necessary optimality conditions, the model's solution can then be analyzed in terms of the hypothetical expectations of the theory of financial authority. The model is thus sufficiently powerful to provide a simple but nuanced representation of the regulatory relationship between a publicly minded central banker and a self-concerned bank manager.

2.22 (A) Timing

The timing of the model begins when the CB offers the BM a set of regulatory contracts that specify the capital-asset combinations that expand credit at a constant rate and that preserve the solvency of the banking sector. If the BM accepts the terms of the regulatory contract, the BM chooses an asset, a_i , from the set of possible asset types: $a = \{a_i\}$ and a level of loan loss reserves: $k = \{k_j\}$. Once the BM has selected a asset-reserves combination, the CB observes the actions and responds by selecting a regulatory action from its action space; $r = \{r_i, 1 - r_i\}$ where r_i = forbearance and $(1 - r_i)$ = intervention. Each player's resulting utility is given by the utility functions $U_{BM} = (a, k, r)$ and $U_{CB} = (a, k, r)$.

2.22 (B) Contract Theory and Regulatory Design

The explicit specification of the regulatory contract must include a full consideration of the constraints upon the bank manager's decisions as well as all limitations upon the central bank's decision-making environment. Given that the BM's asset and reserves decisions are common knowledge, what follows is a specification of a perfect information regulatory contract between the BM and the CB.

(i) The Bank Manager's Rights: The BM controls the bank's credit allocation decisions a_i , and the bank's loan loss provisions, k_j , which corresponds to the cost of capital, c_j . By approving a loan a_i , the BM gains a share of the revenue stream G_i and pays a cost c_j .

(ii) The Bank Manager's Obligations: The BM's should select either $\{a_0, k_1\}$ or $\{a_1, k_0\}$. Should the BM behave accordingly, then the BM will retain their executive control rights and the CB should practice regulatory forbearance.

(iii) The Central Bank's Rights: The CB sets the prudential standards by which the BM must abide. Should the BM fail to obey the CB's regulatory statutes, the CB has the right to intervene in the bank's operations in order to correct any balance sheet sub-optimality. Should the BM select either $\{a_0, k_0\}$ or $\{a_1, k_1\}$, the bank's balance sheet will be corrected to $\{a_0, k_1\}$ and $\{a_1, k_0\}$ respectively. Furthermore, should the BM violate the terms of the regulatory contract, the CB is empowered to re-distribute the BM's revenue share, $v_{ii} \leq G_i$, to minority shareholders.

(iv) Central Bank's Obligations: The CB is constitutionally invested with multiple obligations, which includes enforcement of prudential regulatory statutes. The CB is also responsible for monetary policy and is thus ostensibly committed to achieving the government's publicly announced credit target; $x(a_i, k_i) = 0$. The CB is also politically bound to fulfill the government's monetary obligations, which could force the CB to diverge from its constitutionally mandated responsibility to maintain a constant rate of credit expansion. Finally, the CB is required to provide lender of last resort facilities, by absorbing $(a_i + k_i) \leq 0$ should the BM obey the government's regulatory statutes.

2.22 (C) Bank Manager's Strategy

The bank manager's goal is to maximize their personal income within a regulatory environment that is circumscribed by the central bank's possible actions. The constraints imposed upon the bank manager's governance decisions by the regulatory contract can be more precisely described in terms of the bank manager's incentive compatibility constraint.

(i) Incentive Compatibility Constraint

$$\{a, k\} = \arg \max \left\{ G_i - c_j + (a_i + k_j) \right\} \quad (2.41)$$

The incentive compatibility conditions yields the parameter values under which bank manager will abide by the capital-asset decisions implied by the terms of the prudential regulatory contracts. The bank manager's decisions are also constrained by the central bank's possible actions; a full description of which requires the specification of the central bank's decision-making environment

(ii) The Central Bank's Dilemma

The potential conflict between monetary expansion and banking regulation is captured formally by defining the CB's utility in terms of the consequences of the monetary and fiscal consequences of regulatory action. An expansion of the domestic credit supply enters the CB's utility function as $x(a_i, k_i)$. Furthermore, regulatory intervention into a bankrupt institution's affairs implies that CB will impose a penalty of $(a_i + k_j) \leq 0$ upon the BM (which is the bank's net worth position). Alternatively, forbearance implies that CB will grant the BM lender of last resort facilities by absorbing $(a_i + k_j) \leq 0$ should the BM behave in accordance with the terms of the regulatory contract. Formally the CB's utility function can be represented as follows:

$$U_{CB}(a, k) = x(a_i, k_j) + (a_i + k_j) - z_k \quad (2.43)$$

Where $x(a_0, k_0) > 0$, $x(a_0, k_1) = x(a_1, k_0) = 0$, and $x(a_1, k_1) < 0$.

The cost of intervention, z_k , is distributed such that the CB will incur z_1 if the CB's intervention is warranted, and z_0 is incurred if the CB's intervention is unwarranted, and $z_0 > z_1 > 0$. Note that $x(a_0, k_0) > 0$ represents an acceleration in the rate of credit expansion, and that by contrast, $x(a_1, k_1) < 0$ represents a deceleration in the rate of credit expansion (i.e. a credit contraction), while $x(a_0, k_1)$ and $x(a_1, k_0)$ achieve the statutory target of a constant rate of monetary expansion, such that $x(a_i, k_j) = 0$. Because the government's domestic constituents prefer an acceleration of monetary expansion, $x(a_0, k_0) > 0$, the CB has an incentive to diverge from its commitment to maintain a constant rate of credit expansion, $x(a_i, k_j) = 0$. Therefore, the CB's mandate to expand the money supply at a constant rate is not necessarily incentive compatible with the government's regulatory commitments. And as consequence of the components of equation 2.43, the CB now faces a potential

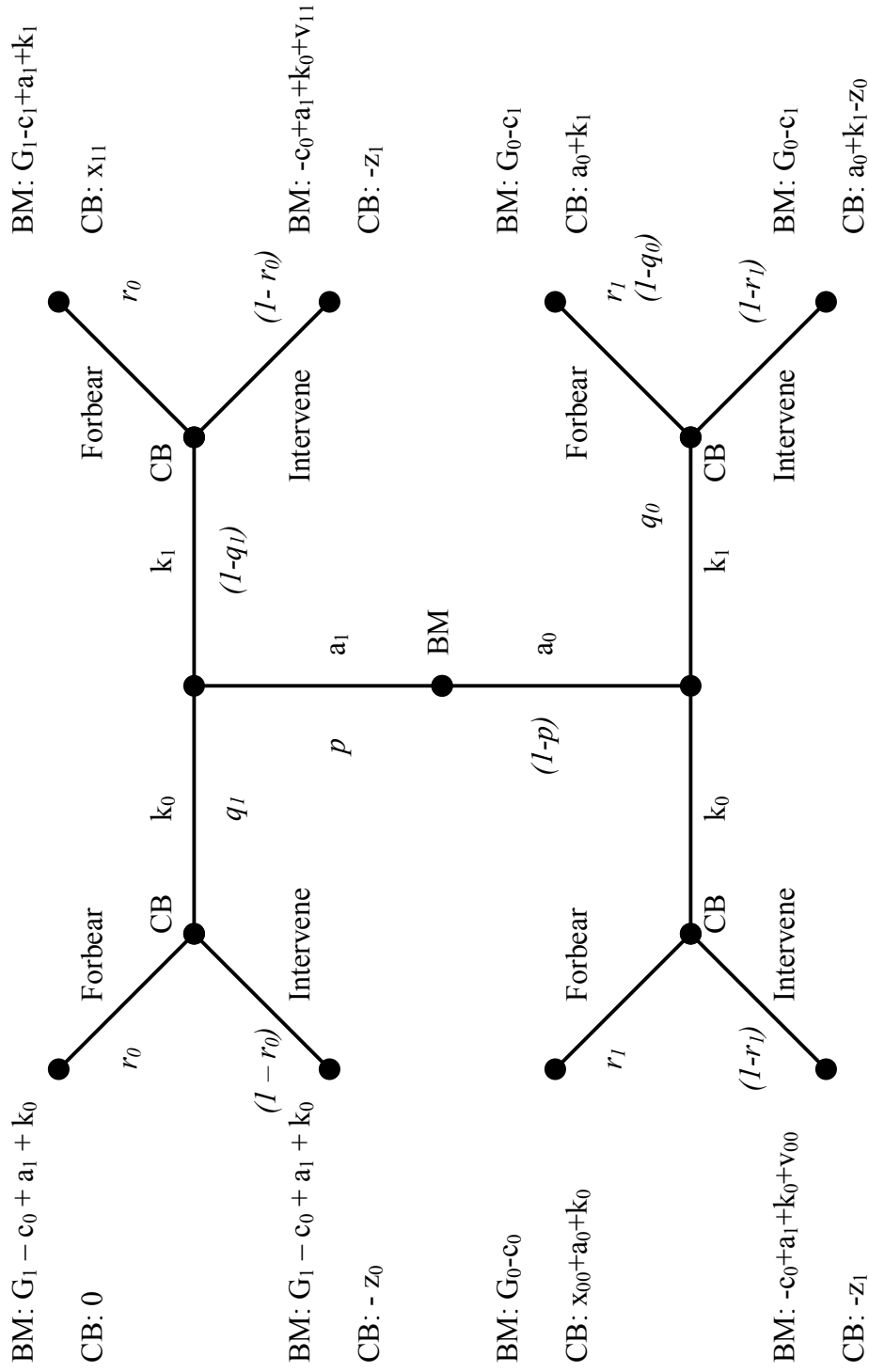


Figure 2.2: Extensive Form of Financial Authority in a Closed Economy

trade-off between the benefits of monetary expansion and the requirements of prudential financial regulation.

(iii) The Monetary Consequences of Regulatory Action

The full statement of the CB's optimal regulatory behavior would thus include a statement of the central bank's mandated policy goals as well as the bank manager's strategic governance decisions:

$$\max_{\{a_i, k_j\}} U_{CB}(a, k) = x(a_i, k_j) + (a_i + k_j) - z_k \quad (2.44)$$

$$\text{s. t.} \quad \{a_i, k_j\} = \arg \max \{G_i - c_j + (a_i, k_j)\} \quad (2.45)$$

Equations 2.44 – 2.45 complete the specification of the prudential regulatory contract, which is represented formally as a constrained optimization problem. The solution to the optimization problem proceeds by applying the Kuhn Tucker conditions as well as the global optimization condition, which compares candidate solutions to all possible permutations of the regulatory contract. Now that the actors' incentives have been fully specified, the extensive form of the contractual relationship between the bank manager and the central bank can be represented in Fig 2.3 above:

2.3 Interpreting Financial Authority

The solution to the perfect information regulatory contract is organized conceptually in terms of six distinct Nash equilibria. Each equilibrium corresponds to a regulatory scenario that illustrates the parameter values that are necessary to enforce the terms of the regulatory contract, as well as the parameter values under which one,

or both, of the contracting parties will violate the terms of the regulatory agreement. More precisely, the regulatory scenarios illustrated in Table 2.4 summarize all six pure-strategy Nash equilibria that can be realized by the model, given the contractual limitations imposed upon the decisions of the bank manager and the central bank.

Each equilibrium scenario is organized conceptually in terms of the actors' strategic decisions as well as the consequences of those decisions for the stylized regulatory system represented by the model. Accordingly, the six Nash equilibria can be divided into three categories; (i) *regulatory failure*, in which the bank manager's governance decisions result in crisis level inflation or deflation, (ii) *regulatory discipline*, wherein both parties meet their respective contractual obligations, and (iii) *regulatory prejudice*, which analyzes the condition under which the central bank is willing to intervene in the operations of the banking system.

2.4 Solution

I. Expected Utility Functions:

$$U_{BM} = U \{a_i, k_j, g_i(a_i), c(k_j), v(a_i, k_j)\}; \text{ where } i, j = 0, 1 \quad (A.1)$$

$$U_{CB} = U \{a_i, k_j, x(a_i, k_j), z(a_i, k_j)\}, \text{ where } i, j = 0, 1 \quad (A.2)$$

The following constraints and definitions are exogenously imposed upon the parameters:

$x_{00} \geq 0$;	Monetary expansion
$x_{11} \leq 0$;	Monetary contraction
$a_0 \leq 0$;	Value of a failed asset
$a_1 \geq 0$;	An asset with a positive value
$k_0 \geq 0$;	Low level of regulatory capital

$k_1 \geq 0$;	High level of regulatory capital
$c_0 \geq 0$;	Cost of low level capital
$c_1 \geq 0$;	Cost of high level capital
$g_0 \geq 0$;	BM's profit from failed asset
$g_1 \geq 0$;	BM's profit from a positive valued asset
$v_{00} \geq 0$;	BM's remaining profit from a failed asset following regulatory intervention
$v_{11} \geq 0$;	BM's remaining profit from the good asset following regulatory intervention
$z_0 \geq 0$;	CB's low cost of intervention
$z_1 \geq 0$;	CB's high cost of intervention

Further exogenous constraints:

$$\begin{aligned}
k_0 - c_0 &\geq 0 \\
k_1 - c_1 &\geq 0 \\
g_0 - c_0 &\geq 0 \\
a_1 - a_0 &\geq 0 \\
k_1 - k_0 &\geq 0 \\
z_1 - z_0 &\geq 0 \\
g_0 - g_1 &\geq 0 \\
x_{00} - x_{11} &\geq 0 \\
c_1 - c_0 &\geq 0
\end{aligned}$$

The parameter values are associated with the decisions of the BM and CB in the following manner:

$$\begin{aligned}
p = 0; & \text{ BM selects } a_0 \\
p = 1; & \text{ BM selects } a_1 \\
q_0 = 0, & \text{ BM selects } k_0 - c_0 \\
q_0 = 1; & \text{ BM selects } k_1 - c_1 \\
q_1 = 0; & \text{ BM selects } k_0 - c_0 \\
q_1 = 1; & \text{ BM selects } k_1 - c_1 \\
r_0 = 0; & \text{ CB selects intervention} \\
r_0 = 1; & \text{ CB selects forbearance} \\
r_1 = 0; & \text{ CB selects intervention} \\
r_1 = 1; & \text{ CB selects forbearance}
\end{aligned}$$

The BM's problem translates into a selection of values of a_i and k_j that maximize:

$$\begin{aligned}
EU_{BM} = & \{p \cdot q_1 \cdot r_0 \cdot [g_0 - c_0 + a_1 + k_0]\} + \{p \cdot q_1 \cdot (1 - r_0) \cdot [g_1 - c_0 + a_1 + k_0]\} \\
& + \{(1 - p) \cdot q_0 \cdot r_0 \cdot [g_0 - c_0]\} + \{(1 - p) \cdot q_0 \cdot (1 - r_0) \cdot [-c_1 + a_0 + k_1 + v_{00}]\} \\
& + \{p \cdot (1 - q_1) \cdot r_1 \cdot [g_1 - c_1 + a_1 + k_1]\} + \{p \cdot (1 - q_1) \cdot (1 - r_1) \cdot [-c_0 + a_1 + k_0 + v_{11}]\} \\
& + \{(1 - p) \cdot (1 - q_0) \cdot r_1 \cdot [g_0 - c_1]\} + \{(1 - p) \cdot (1 - q_0) \cdot (1 - r_1) \cdot [g_0 - c_1]\}
\end{aligned} \tag{A.3}$$

The CB's problem is to select a best response that maximizes:

$$\begin{aligned}
EU_{CB} = & \{p \cdot q_1 \cdot r_0 \cdot [0]\} + \{p \cdot q_1 \cdot (1 - r_0) \cdot [-z_0]\} \\
& + \{(1 - p) \cdot q_0 \cdot r_0 \cdot [x_{00} + a_0 + k_0]\} + \{(1 - p) \cdot q_0 \cdot (1 - r_0) \cdot [-z_1]\} \\
& + \{p \cdot (1 - q_1) \cdot r_1 \cdot [x_{11}]\} + \{p \cdot (1 - q_1) \cdot (1 - r_1) \cdot [-z_1]\} \\
& + \{(1 - p) \cdot (1 - q_0) \cdot r_1 \cdot [a_0 + k_1]\} + \{(1 - p) \cdot (1 - q_0) \cdot (1 - r_1) \cdot [a_0 + k_1 - z_0]\}
\end{aligned} \tag{A.4}$$

II. Lagrange Multipliers:

The action space of the CB is defined by the set $\{r_0, r_1\} \in [0, 1]$, and the action space of the BM is defined by the set $\{p, q_0, q_1\} \in [0, 1]$. The equilibrium strategy space of each player is subject to the following constraints.

$$L_{CB} = \lambda_1 (1 - r_1) + \lambda_2 (1 - r_0) \tag{A.5}$$

$$L_{BM} = \lambda_3 (1 - p) + \lambda_4 (1 - q_1) + \lambda_5 (1 - q_0), \tag{A.6}$$

Objective functions for the players then become:

$$CB = EU_{CB}(v) + \lambda_1 (1-r_1) + \lambda_2 (1-r_0) \quad (A.7)$$

$$BM = EU_{BM}(w) + \lambda_3 (1-p) + \lambda_4 (1-q_1) + \lambda_5 (1-q_0) \quad (A.8)$$

III. First Order Conditions and Slackness Conditions:

First order conditions and the necessary conditions for an optimum are given by:

$$\begin{aligned} [\partial EU_{CB} / \partial r_1] * r_1 = & \quad r_1[p(1-q_0)(x_{00})-p(1-q_1)(x_{11}-z_1) \\ & +(1-p)(1-q_0)(x_{00}+a_0+k_1) \\ & -(1-p)(1-q_0)(x_{00}+a_0+k_0-z_0)-\lambda_1] = 0 \end{aligned} \quad (A.9)$$

$$\begin{aligned} [\partial EU_{CB} / \partial r_0] * r_0 = & \quad r_0[pq_1(x_{11})-pq_1(x_{11}-z_0)+(1-p)q_0(x_{00}+a_0+k_0) \\ & -(1-p)q_0(x_{00}-z_1)-\lambda_2] = 0 \end{aligned} \quad (A.10)$$

$$\begin{aligned} [\partial EU_{BM} / \partial p] * p = & \quad p[(qr_0(g_0-c_0+a_1+k_0)+q(1-r_0)(g_1-c_0+a_1+k_0) -q_0 r_0 (g_0-c_0) \\ & -q_0(1-r_0)(-1+r_1+a_0+k_1+v_{00}) + (1-q_1) r_1 (g_1-1+r_1+a_1+k_1) -(1-q_1)(1-r_1)(-c_0+a_1+k_0+v_{11}) \\ & -(1-q_0) r_1 (g_0-1+r_1)-(1-q_0)(1-r_1)(g_0-1+r_1)-\lambda_3] = 0 \end{aligned} \quad (A.11)$$

$$\begin{aligned} [\partial EU_{BM} / \partial q_1] * q_1 = & \quad q_1[(pr_0 (g_1-c_0+a_1+k_0)+p(1-r_0)(g_1-c_0+a_1+k_0) \\ & -pr_1(g_1-1+r_1+a_1+k_1)-p(1-r_1)(-c_0+a_1+k_0+v_{11})-\lambda_4] = 0 \end{aligned} \quad (A.12)$$

$$\begin{aligned} [\partial EU_{BM} / \partial q_0] * q_0 = & \quad q_0[(1-p)r_0(g_0-c_0)+(1-p)(1-r_0)(-1+r_1+a_0+k_1+v_{00}) \\ & -(1-p)r_1(g_0-1+r_1)-(1-p)(1-r_1)(g_0-1+r_1)-\lambda_5] = 0 \end{aligned} \quad (A.13)$$

$$F_1 = \lambda_1(1-r_1) = 0 \quad (\text{A.14})$$

$$F_2 = \lambda_2(1-r_0) = 0 \quad (\text{A.15})$$

$$F_3 = \lambda_3(1-p) = 0 \quad (\text{A.16})$$

$$F_4 = \lambda_4(1-q_1) = 0 \quad (\text{A.17})$$

$$F_5 = \lambda_5(1-q_0) = 0 \quad (\text{A.18})$$

Since the constraints are inequality constraints, the Kuhn-Tucker theorem applies, and for each constraint, either the multiplier will be zero or the constraint will be slack.

IV. Global Optimality Conditions

The action space of each player can be defined by:

$$CB_{00} = (r_1=0, r_0=0);$$

$$CB_{01} = (r_1=0, r_0=1);$$

$$CB_{10} = (r_1=1, r_0=0);$$

$$CB_{11} = (r_1=1, r_0=1);$$

$$BM_{000} = (q_1=0, q_0=0, p=0);$$

$$BM_{001} = (q_1=0, q_0=0, p=1);$$

$$BM_{010} = (q_1=0, q_0=1, p=0);$$

$$BM_{011} = (q_1=0, q_0=1, p=1);$$

$$BM_{100} = (q_1=1, q_0=0, p=0);$$

$$BM_{101} = (q_1=1, q_0=0, p=1);$$

$$BM_{110} = (q_1=1, q_0=1, p=0);$$

$$BM_{111} = (q_1=1, q_0=1, p=1);$$

The global optimum is determined by comparing equilibrium strategies that satisfy the Kuhn-Tucker conditions, with every other permutation of the game.

Let EUCB and EUBM designate equilibrium strategies that satisfy the Kuhn-Tucker conditions. Then, the CB's equilibrium strategy will be a global optimum only if it satisfies:

$$\forall i, j (EUCB - CB_{ij}) \geq 0, \text{ where: } i, j = 0, 1;$$

Similarly, the BM's equilibrium strategy will be a global optimum only if it satisfies:

$$\forall i, j, k (EUBM - BM_{ijk}) \geq 0, \text{ where: } i, j, k = 0, 1.$$

V. Nash Equilibria

The solution space for contract Γ is defined by six pure strategy Nash Equilibria.

(1) The BM selects $\{p = 0; q_0 = 1\}$, while the CB responds by $\{r_0 = 1\}$

$$\text{From the Kuhn Tucker conditions: } g_1 > v_{11} \quad (\text{A.19})$$

$$EUCB - CB_{00} = EUCB - CB_{10} = a_0 + k_0 + z_1 \geq 0 \quad (\text{A.20})$$

$$EUBM - BM_{000} = 1 - c_0 \geq 0 \quad (\text{A.21})$$

$$EUBM - BM_{001} = g_0 - v_{11} - (a_1 + k_0) \geq 0 \quad (\text{A.22})$$

(2) The BM selects $\{p = 0; q_0 = 1\}$, and the CB responds by $\{r_0 = 0\}$.

$$\text{From the Kuhn Tucker conditions: } (a_0 + k_0) + z_0 \leq 0 \quad (\text{A.23})$$

$$EUCB - CB_{01} = EUCB - CB_{11} = (a_0 + k_0) + z_0 \leq 0 \quad (\text{A.24})$$

$$EUBM - BM_{000} = EUBM - BM_{100} = \{a_0 + k_1 - g_0 + v_{00}\} \geq 0 \quad (\text{A.25})$$

(3) The BM selects $\{p = 0; q_0 = 0\}$, while the CB responds by $\{r_1 = 1\}$

$$EUCB - CB_{01} = z_0 \geq 0 \quad (A.26)$$

$$EUBM - BM_{001} = EUBM - BM_{011} = g_0 - g_1 - (a_1 + k_1) \geq 0 \quad (A.27)$$

$$EUBM - BM_{101} = EUBM - BM_{111} = g_0 - g_1 + c_0 - (a_0 + k_1) \geq 0 \quad (A.28)$$

(4) The BM selects $\{p = 1; q_1 = 1\}$, while the CB's best response is $\{r_0 = 1\}$

$$EUCB - CB_{01} = z_0 \geq 0 \quad (A.29)$$

$$EUBM - BM_{000} = EUBM - BM_{100} = a_1 + k_0 - (g_0 - g_1) + 1 - c_0 \geq 0 \quad (A.30)$$

$$EUBM - BM_{001} = EUBM - BM_{011} = g_1 - v_{11} \geq 0 \quad (A.31)$$

$$EUBM - BM_{010} = EUBM - BM_{110} = a_0 + k_1 - (g_0 - g_1) \geq 0 \quad (A.32)$$

(5) The BM selects $\{p = 1; q_1 = 0\}$, while the CB responds by $\{r_1 = 0\}$.

$$\text{From the Kuhn Tucker conditions: } x_{11} + z_1 = 0 \quad (A.33)$$

$$EUCB - CB_{00} = EUCB - CB_{01} = x_{11} + z_1 = 0 \quad (A.34)$$

$$EUBM - BM_{000} = EUBM - BM_{100} = 1 - c_0 + a_1 + k_0 - g_0 + v_{11} \geq 0 \quad (A.35)$$

$$EUBM - BM_{101} = EUBM - BM_{111} = g_1 - v_{11} \geq 0 \quad (A.36)$$

(6) The BM selects $\{p = 1; q_1 = 0\}$, while the CB responds by $\{r_1 = 1\}$.

$$\text{From the Kuhn Tucker conditions: } (a_1 + k_1 + c_0 - a_1 + k_0) = 0 \quad (A.37)$$

$$EUCB - CB_{00} = EUCB - CB_{01} = (x_{11} + z_1) \geq 0 \quad (A.38)$$

$$EUBM - BM_{000} = EUBM - BM_{100} = (g_1 - g_0 + a_1 + k_1) \geq 0 \quad (A.39)$$

$$EUBM - BM_{101} = EUBM - BM_{111} = (a_1 + k_1 + c_0 - a_1 + k_0) \geq 0 \quad (A.40)$$

VI. Remarks and Proofs

Remark 1: Regulatory Failure. The CB causes a boom-bust cycle, equilibrium (1); or a bust-boom cycle, equilibrium (6); when the BM selects bankruptcy (a_0, k_0) or selects over-capitalization (a_1, k_1) respectively, and the CB responds with regulatory forbearance.

By corollary, the CB thereby induces monetary and fiscal instability, which privileges the BM's preferences and forces the CB to absorb the costs of the resulting inflation or deflation.

Proof: From the global optimality conditions, the BM will select bankruptcy as long as the cost under-capitalization is sufficiently low, $c_0 \leq 1$ (condition A.21), and as long as the BM's payoff will be superior to abiding by the contract: $g_0 - v_{11} \geq a_1 + k_0$ (condition A. 22). From the KT condition $g_0 > v_{11}$ (condition A.19) that implies that the BM's utility gain from bankruptcy is greater than the compensation that the BM receives from regulatory intervention.

The CB's commitment to enforce the contract will be *incredible* if the costs of enforcing the contract are higher than the costs of failing to do so: $a_0 + k_0 \geq -z_1$ (condition A.20). Alternatively, the BM will select over-capitalization as long as the resulting portfolio yields: $a_1 + k_1 = k_0 - c_0 \geq g_0 - g_1$ (conditions A.37-39). The CB's contract enforcement will also be *incredible* if the resulting deflation is generates less social cost than intervention: $x_{11} \geq -z_1$.

Remark 2: Regulatory Prejudice. The CB's intervention promotes monetary and fiscal stability, equilibrium (2) and equilibrium (5), when the costs of intervention are outweighed by the social cost of practicing forbearance, and the BM is compensated following intervention.

Proof: If the BM violates the regulatory contract by selecting bankruptcy (a_0, k_0) , and the CB intervenes, the resulting outcome for the CB only if the social cost of intervention is less the cost of forbearance: $a_0 + k_0 \geq g_0 - v_{00}$; (conditions A.23-24)

The value of the BM's post-intervention portfolio must also compensate the BM for profits seized by the CB: $a_0 + k_1 \geq g_0 - v_{00}$ (condition A.25).

If the BM violates the contract by selecting an inefficiently high level of capital (a_1, k_1) , and the CB intervenes, the outcome will be stable only if the cost of intervention is outweighed by the social cost of the deflation that would have resulted had the CB practiced forbearance: $x_{11} = -z_1$; (conditions A.33-34)

The BM will accept intervention if he is at least partially compensated for the seizure of his assets: $(a_1 + k_0) \geq g_0 - v_{11} + c_0 - 1$ (condition A.35)

Remark 3: Regulatory Discipline. The regulatory contract is credible, equilibrium 3 and equilibrium 4, when the BM voluntarily selects optimal capitalization, and the CB practices forbearance.

Proof: The regulatory contract will be incentive compatible for the BM, equilibrium (3) and equilibrium (4), only if the resulting portfolio (a_0, k_1) and (a_1, k_0) respectively generate a utility that is superior to violating the contract.

Hence, incentive compatibility is guaranteed in equilibrium (3), only if the BM's utility yields: $a_0 + k_1 \geq g_0 - g_1 + c_0$ (condition A.28). Incentive compatibility is similarly guaranteed in equilibrium (4) only if the BM's utility yields: $a_1 + k_0 \geq g_0 - g_1 + c_0 - 1$ (condition A.30)

Regulatory forbearance is incentive compatible for the CB in both cases as long as intervention is costly: $z_0 \geq 0$ (conditions A.26 and A.29).

Chapter 3
Financial Authority and Government
The Exogenous Dimensions

3.1 Introduction

The model of financial authority presented in chapter two presumes an exogenous set of the political and institutional dimensions that define each actor's utility function. The public regulator and bank manager's strategic decisions are made with the boundaries of a regulatory contract, the terms of which are negotiated within the broader political, economic, and social constraints that prevail within each country. Each economy exists within a specific geopolitical context and each country contains unique institutional features. These dimensions are pre-determined by a country's location on the surface of the Earth and the historical development of the banking system. Consequently, any hypotheses generated by the model can be evaluated only in the context of a more general framework that systematically incorporates each actor's decision-making environment.

Accordingly, the model's exogenous dimensions can be divided into four conceptual categories; 1) the corporate organization of the banking system, which substantively defines the bank manager's utility function, 2) the constraints that inform the trade-off between the government's monetary and regulatory commitments, 3) the institutional conditions that circumscribe the post-crisis distribution of bankruptcy costs, and, 4) the exogenous institutional factors which determine the post-crisis allocation of executive control rights. Once the exogenous dimensions of the model have been fully specified, I will then use the Mundell-Fleming macroeconomic framework in order to analyze the challenges of preserving financial authority in the monetary environment of the open economy. In particular, I will evaluate the distributional conflicts that arise in the special case of an open capital account with a fixed exchange rate regime, which completes the substantive interpretation of the model's results.

3.2 Financial Authority and Government

The bank manager utility and central bank's utility are defined by an exogenous set of political and institutional dimensions, that also explain the distribution of the pure strategy Nash equilibria illustrated in Table 2.4 of the previous chapter. The exogenous dimensions of financial authority are displayed in Table 3.1 below, which is organized conceptually in order to explain the institutional and political changes that are necessary to move empirically from one regulatory scenario to another. The contents of Table 3.1 would then represent a mapping, from the range of parameter values implied by the regulatory scenarios, into the domain of financial system dynamics that are more fully explored in the ensuing empirical chapters.

Table 3.1 is divided into four exogenous dimensions that, in principle, can fully account for the variance of parameter values across the regulatory scenarios. Each exogenous dimension is further divided into two substantive categories. The first category, which is designated as "authority," identifies the relevant actor or branch of government in which decision making authority over each of the exogenous dimensions is invested. The second substantive category, designated as "decision making environment," describes the broader institutional configuration and political relationships that define each actor's decision-making environment. Most importantly however, Table 3.1 is organized in terms of pre-crisis and post-crisis contexts, and it is the alteration of the exogenous dimensions, between the pre and post crisis contexts, that is ultimately responsible for the variance of the parameter values that occurs when we move empirically from one regulatory scenario to another.

Table 3.1: Exogenous Dimensions of Financial Authority

	<u>Pre-Crisis</u>	<u>Post-Crisis</u>
<u>A. Bank Governance</u>		
1. Authority	- Board of Governors	MoF/Central Bank
2. Decision making Environment	- Corporate Organization of the Banking System	- Risk Management Reform - Governance Reforms - Accounting and Disclosure Reforms
<u>B. Macro trade-off</u>		
1. Authority	- Central Bank - Ministry of Finance - Other Regulators	- Prime Minister/President (extraordinary powers)
2. Decision making Environment	- Exchange rate Constraint - Monetary Constraint - Natl. Security Constraint - Executive Branch Action	- Exchange rate Reform - Monetary Reform - Regulatory Reform - Political Reform
<u>C. Bankruptcy Costs</u>		
1. Authority	- Ministry of Finance	- Prime Minister/President (extraordinary powers)
2. Decision making Environment	- No Clear Framework	- Institutional Innovation
<u>D. Executive Control Rights</u>		
1. Authority	- Ministry of Finance	- Prime Minister/President - Outside/Foreign Ownership
2. Decision making Environment	- No Clear Framework (Banking Law)	- Institutional Innovation

A. The Corporate Organization of the Banking System

The first exogenous dimension corresponds to the bank manager's credit allocation and the capital reserves decisions. In any economy, credit allocation decisions are the province of each bank's board of governors, which is represented by the bank manager in the model. In a pre-crisis context, the bank manager's incentives are represented by the payoff that the manager receives in regulatory scenario (1) and (5). However, once a crisis has occurred or corrective regulatory action becomes necessary, the ministry of finance and central bank normally assume control over the bank's future decisions, which includes the correction of the bank's balance sheet in the manner predicted by regulatory scenarios (2) and (5). Empirically, and beyond the confines of the model, the scope of the public intervention depends on the extent to which a country's banking laws have been violated, and hence, the government's remedies could range anywhere from nominal fines to the temporary nationalization of a failed bank.²²

The realization of the bank manager's utility is also determined by the manager's decision-making environment, which translates substantively into the corporate organization of the banking system. For instance, the bank manager's incentive to extend a "bad loan" is empirically plausible because in many countries, commercial banks are either family owned businesses or government owned financial institutions. Moreover, banks are often at the center of larger holding companies or corporate conglomerates, which creates opportunities for "insider lending," on terms that would otherwise be unacceptable in a competitive credit market. The bank-holding company structure that characterizes the Thai economy and the *grupo* conglomerates that dominated the Chilean economy in the 1970s and 1980s are

²² Goodhart, Charles, E., et. al., *Financial Regulation: Why, How, and Where Now?*, (New York: Routledge Press, 1998), 61-72

examples of bank-business relationships that encouraged insider lending and self-loans.²³ Furthermore, the widespread preferential credit links between government banks and state-owned enterprises, or between private banks and larger corporate affiliates, will almost always lead to a higher level of failed loans. Finally, in order to gain access to political privileges, banks in many countries will often provide campaign financing for political candidates, and may even extend bribes to high-level government officials, which would also lead to a higher level of non-performing loans.²⁴

Reforming the corporate organization of the banking sector is a necessary precondition for any post-crisis solution to flaws in the national system of financial governance. Radical or socialist or revolutionary groups (*grupos*) can be broken up or banks can be separated from conglomerates, Taiwan following the 1939 financial crisis. Less disruptive of the property rights of the equity holders is introduction of outside investors to the board of governors. Foreign ownership is supposed to play the role that the state or military once played, which is to moderate the loan behavior of the primary shareholder, who is represented by the bank manager's utility. Decision making behavior of the bank manager will be altered significantly, because there is another powerful counter-balance to the manager's discretion. Given the manner in which corporate reform will have upon the property rights of individuals, family ownership of domestic financial institutions, and the pattern of ownership in domestic banks, financial governance reforms. Creating the mechanism by which the corporate-bank is inherently political. Whether through personal relations between the business owners and prominent political figures, such as the monarchy in

²³ Richard Doner and Daniel Unger, "The Politics of Finance in Thai Economic Development," In Stephan Haggard, et. al., editors: *The Politics of Finance in Developing Countries* (Ithaca: Cornell University Press, 1994), 93-122; Laura A. Hastings, "Regulatory Revenge: The Politics of Free-Market Financial Reforms in Chile," In Stephan Haggard, et. al., *The Politics of Finance in Developing Countries*, 201-229

²⁴ See Chapter 3 and Chapter 4

Thailand or between the government and bank owners as in Mexico between 1950 and 1982 and 1989 and 1994.

Across the developing world, governments have maintained control over the banking sector since modern banks first started appearing in the developing world in the late 19th century. The corporate organization of the banking sector is thus determined by broader political imperatives, such as national industrial policies and geopolitical objectives. These factors are exogenous to the model presented in chapter two, but are critical for understanding the distribution of power both within government, and the outcome of the struggle between governments and native capitalists over control of the banking sector.

B. The Dilemmas of Financial Authority

The link between a government's broader political goals and the control over the banking sector can only be established if we can connect bank lending and monetary policy. In order to clarify this link, I built the model in the model presented in chapter two upon the "credit view" of monetary policy. The credit view of monetary policy argues that an expansion of the domestic money supply stimulates the credit allocation activities of banks, which has an independent positive effect upon investment levels and upon overall economic output. As a result, the macro dynamics described by the model are empirically plausible.²⁵ Since banks provide

²⁵ The credit view of monetary policy is founded upon three Neo-Keynesian assumptions: 1) prices will not adjust instantaneously to changes in the quantity of money, 2) the central bank can directly influence the volume of credit by adjusting bank reserves, and, 3) loans and securities are imperfect substitutes for borrowers and for banks. See: Bernanke, B. S. and A. S. Blinder, "Credit, Money and Aggregate Demand," *American Economic Review*, 78, no. 2 (May 1988): 435-439; B. S. Bernanke and M. Gertler, "Inside the Black Box: The Credit Channel of Monetary Policy Transmission," *Journal of Economic Perspectives*, 9, no. 4 (Fall 1990): 27-48; A. N. Kashyap, et. al., "Monetary Policy and Credit Conditions: Evidence from the Composition of External Finance," *American Economic Review*, 83, no. 1 (March 1994): 78-79

between 60 to 90 percent of all financing in developing countries, regulatory action will have definite distributional consequences upon the different sectors of society. The trade-off that the central bank must face in the model, between credit expansion and banking regulation, will then reflect the wider balance of power between the domestic actors who populate the central bank's exogenous decision-making environment.

Table 3.2: The Distribution of the Costs and Benefits of Regulatory Action

	<u>Central Bank</u>	<u>Bank Manager</u>	<u>Taxpayers</u>	<u>Minority Shareholders</u>
Scenario (1)	$x_{00} > 0$	$G_0 - c_0$	$(a_0 + k_0) < 0$	0
Scenario (2)	$x_{01} = 0$	$-c_1$	$-z_1$	$(a_0 + k_1) \leq 0; v_{00} \leq G_{00}$
Scenario (3)	$x_{01} = 0$	$G_0 - c_1$	$(a_0 + k_1) \leq 0$	0
Scenario (4)	$x_{10} = 0$	$G_1 - c_0$	0	$(a_1 + k_0) \geq 0$
Scenario (5)	$x_{10} = 0$	$-c_0$	$-z_1$	$(a_1 + k_0) \geq 0; v_{11} \leq G_{11}$
Scenario (6)	$x_{11} < 0$	$G_1 - c_1$	0	$(a_1 + k_1) > 0$

The change in the magnitude of the model's macro parameters across regulatory scenarios is explained empirically by the variation of the exogenous dimensions illustrated in Table 3.1. The exogenous macro-level constraints are indeterminate with regards to the trade-off between credit expansion and (future debt) banking regulation, in that macro-constraints can impose either a minimum or a

maximum level of credit expansion upon the government. At the most general level, the model's solution generated three categories of macro-outcomes; i) a credit boom, associated with the acceleration of the rate of credit expansion implied by scenario (1); (ii) a credit contraction, which is represented in the model by the deceleration of the rate of credit expansion illustrated in regulatory scenario (6); and iii) credit market stability, which is illustrated by regulatory scenarios (3) and (4). A simplified version of the distributive consequences of regulatory action is depicted in Table 3.2 below.²⁶

Substantively, a central bank may accelerate the rate of credit expansion, represented by regulatory scenario (1), in order to provide wage supports for labor unions, or subsidies for the agricultural sector, or selective credit outlays to high profile firms and government connected industries. Much of the “developmental state” literature, is in fact premised upon the powers of selective credit allocation that Asian governments exercised during the high growth phase of economic development.²⁷ However, according to the regulatory consequences of scenario (1), in order to accelerate the credit supply, the government must tolerate a higher incidence of bad loans and bankruptcy. Supplying state-owned enterprises or large private conglomerates with selective access to credit would then come at a distributional cost to taxpayers and to the minority shareholders of the banking system, who must ultimately pay the cost for the central bank's credit largesse.²⁸

By contrast, macroeconomic and political constraints can also force a central bank to decelerate the rate of domestic credit expansion, which is illustrated in regulatory scenario (6). For instance, the literature on financial repression has long

²⁶ Table 3.6 is a simplified version of Table 2.3, which I have constructed in order to illustrate the distributive consequences of regulatory action that are implied by the model.

²⁷ Wade, Robert, *Governing the Market* (Princeton: Princeton University Press, 1990), and, Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization*, (New York: Oxford University Press, 1989)

²⁸ Haggard, Stephan, Chung H. Lee, and Sylvia Maxfield, *The Politics of Finance in Developing Countries*, (Ithaca: Cornell University Press, 1994)

documented cases wherein the government intentionally limits the growth of the domestic credit supply as a way of compelling depositors to finance government related projects, or in order to deny political opposition groups access to financial resources.²⁹

Governments may also be forced to commit to a contraction of the domestic credit supply by the International Monetary Fund, which normally provides emergency credit facilities only as part of a broader stabilization policy.³⁰ Credit deceleration also imposes a distributive cost upon the economy, in terms of a slowdown in economic activity or even a prolonged recession, which is often associated with I.M.F. sponsored stabilization programs.³¹ As is illustrated in scenario (6), monetary contraction forces domestic banks to reduce the amount of credit that they provide to the economy, which would leave domestic banks well capitalized, but would also produce an inefficient outcome for the economy as a whole.

Finally, a government may commit to a constant rate of credit growth, which is depicted in regulatory scenarios (3) and (4), as part of a larger development plan that considers both the requirements of economic growth and financial sector stability. Regulatory concerns may also be given priority over credit acceleration for more fundamental reasons. Since banks are the primary source of financing in most countries, the banking system can be a source of economic and political instability, and thus, a government facing an external crisis such as a long-term military conflict

²⁹ Fry, Max, *Money, Interest, and Banking in Economic Development* (Baltimore: Johns Hopkins Press, 2nd Edition, 1997); for the relationship between financial regulation and national security, see Chapter 4

³⁰ The monetary approach to the balance of payments serves as the analytical foundations of the I.M.F.'s stabilization policies. See: Polak, R.J., "Monetary Analysis of Income Formation and Payments Problems," *IMF Staff Papers*, 6 (1), 1957, 1-50, and, Mordechai Kreinin and Lawrence H. Officer, "The Monetary Approach to the Balance of Payments: A Survey," *Princeton Studies in International Finance no. 43*, (Princeton: Princeton University Press, November, 1978)

³¹ Agenor, Pierre-Richard and Peter J. Montiel, *Development Macroeconomics*, (Princeton: Princeton University Press, 1996), 265-293

will enforce prudential regulations rather than permit banks to expand credit uncontrollably. As a consequence, in countries that are militarily vulnerable, the control of the banking system by regulatory authorities will be considered an essential element of national security.³² The relative importance of banking regulation as opposed to the government's monetary commitments will thus vary systematically with a shift in the exogenous dimensions of the public regulator's decision-making environment.

The empirical movement from the forbearance scenarios to the intervention scenarios can be explained in terms of institutional substance of pre-crisis and post-crisis decision contexts. Within the pre-crisis scenarios, decision-making authority regarding the macro-tradeoff is ostensibly the administrative prerogative of each country's ministry of finance, central bank, and the other branches of the economic bureaucracy. However, the post-crisis context is a period of extraordinary politics during which only the executive branch of government will have the legal and political status that is sufficient to authorize fundamental macroeconomic and macro-political reforms. The extraordinary powers of the executive branch are also necessary during the post-crisis phase in order to override the distributional concerns of bank managers and owners, which are depicted in scenarios (2) and (5).

The critical role that the executive branch plays during the post-crisis settlement process raises the deeper question of the most effective statutory relationship between the central bank and the other branches of government. In fact, the degree to which political constraints circumscribe effective regulatory action is a function of the relative position of the public regulator within the wider economic bureaucracy, and more specifically, depends upon the relationship between the central bank and the executive branch of government. Empirically, the relationship between

³² See Chapter 5

the institutional prestige of the central bank and the efficacy of the regulatory system holds across government types, since the powers of regulatory enforcement reside in the executive branch of government in democracies as well as in one-party autocracies.³³

The importance of a close relationship between the executive branch and the public regulator contradicts the primary insight of the literature devoted to the significance of central bank independence. According to the independence hypothesis, the legal independence of a country's central bank is statistically significant for explaining the reduction of inflation within the OECD countries.³⁴ However, in many countries, the central bank is responsible for the management of monetary policy as well as the enforcement of prudential regulatory standards, and yet the regulatory consequences of monetary policy remain largely ignored by the central bank independence literature.³⁵

More generally, even in countries where monetary policy and financial regulation are conducted by separate institutions, in times of political or economic stress, any decisions of national importance regarding macro-tradeoffs are inevitably refocused at the highest level of government. Indeed, the assumption that the political leaders of developing economies would fully delegate either banking regulation or monetary policy to the economic bureaucracy stretches credulity, and contradicts much of the available evidence regarding the politics of central banking.³⁶

³³ The distribution of political authority is reflected in the organization of the political system as well as the manner in which political interests are represented institutionally.

³⁴ Cuikerman, Alex, *Central Bank Strategy, Credibility and Independence*, (Cambridge: MIT Press, 1992); Cuikerman addresses the relationship between monetary policy and banking supervision in Chapter 7, in which he argues that the potential conflict of interest between monetary policy and banking regulation justifies the institutional separation of the two duties.

³⁵ Goodhart, Charles and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision be Separated?" *Oxford Economic Papers*, vol. 47, no. 4 (October 1995), 539-60; In contradiction to Cuikerman's claims, Goodhart and Schoenmaker find little empirical correlation between the separation of duties and the incidence of regulatory failure.

³⁶ See Chapters 4, 5, and 7

And in fact, the observed reality central banking politics in developing countries has led some to conclude that, “central banking may be too important to be left to bankers.”³⁷

In response to the political complexities that surround central banking, many models have been developed that conceive of monetary policy outcomes in terms of the strategic interaction between central bankers, legislators, and cabinet ministers. In principle, legal restrictions can be placed upon the ability of legislators and cabinet ministers to intervene in the monetary operations of a central bank. Conversely, legislators and cabinet ministers may also possess powerful instruments, such as budgetary powers and the ability to dismiss an uncooperative central bank governor, which increase the likelihood of political interference in the formulation and implementation of monetary policy. Overall however, there is no universally accepted institutional configuration that can insure the formal or policy independence of central bank authorities.

Another flaw of the literature is that the entire theoretical debate is primarily focused upon central banking within democracies, which omits a large number of all existing central banks from the discussion.³⁸ By focusing primarily upon the OECD economies, the independence literature is also guilty of selection bias, in that the

³⁷ See: “Independence for Central Banks? It’s Debatable,” *International Herald Tribune*, February, 16, 2001. The author writes: “That central banks should be independent of governments has become a shibboleth. But experience in Asia, as elsewhere, suggests that central banking may be too important to be left to bankers.”

See also: Strum, Jan-Egbert, and Jakob de Haan, “Inflation in Developing Countries: Does Central Bank Independence Matter? New Evidence Based on a New Data Set,” (Unpublished paper: Department of Economics: University of Groningen, Netherlands, 2001), and, Temple, J., “Central Bank Independence and Inflation: Good News and Bad News,” *Economics Letters*, Vol. 61, 215-219. The authors’ data set differs from that of Cuikerman by including high inflation non-OECD developing economies, as well as central banking data from the 1990s, which doubles the number of observations in the data set. Once the data set is expanded accordingly, the statistical significance of central bank independence disappears.

³⁸ To my knowledge, there is no research that has been conducted which incorporates the political distinction between central banking in democracies as compared to central banking experiences in a non-democracy.

literature only admits countries that, for exogenous and long term structural reasons, may be pre-disposed to low inflation in the first instance.³⁹ Once the full range of central bank experiences is admitted into the debate however, it becomes clear that the legal independence of a central bank can be overwhelmed by the ideological and political commitments of the dominant party, the specific political traditions that prevail within each country, as well as a host of other institutional and political realities.⁴⁰

Not only does the independence hypothesis required that the central bank remain immune or insulated from executive branch or legislative pressures, but the independence hypothesis further requires that the central bank remain indifferent regarding to the regulatory implications of monetary policy. Hence, in order for the independence of monetary institutions to function in the manner consistent with the independence hypothesis, presumes the central bank's *hyper-neutrality* with regards to the distributional consequences of its monetary policy trajectory. However, as the model of financial authority demonstrates, regulatory action has distinct distributive consequences for the different sectors of society, and hence, once the full implications of financial regulation have been incorporated into the government's monetary policy decisions, the conceptual significance of central bank independence becomes highly questionable. As a consequence, the relationship between the legal status of a central bank and monetary policy outcomes is at best indeterminate, and furthermore, linear generalizations regarding the relationship between institutional design and macroeconomic outcomes difficult to defend theoretically as well as empirically.⁴¹

³⁹ See footnote 14

⁴⁰ A country's international security position, as in the case of Taiwan or other countries involved in long term military conflicts, is sufficient to make discretion over monetary policy far more important than price stability. However, to the extent that price instability could undermine a government's security, low inflation could also be a priority, regardless of the institutional status of the central bank.

⁴¹ The central bank independence literature draws a distinction between "goal" independence and "instrument" independence. While goal independence refers to the ability of central bankers to autonomously set the central bank's policy target (i.e. such as low inflation), instrument independence

The social consequences of banking regulation create incentives for political conflicts over the distribution of the costs and benefits of government actions. Within a democracy, or in a country undergoing democratic reforms, distributional struggles are expressed through electoral competition that involves candidates who represent the banking sector, as well as through parliamentary battles over financial sector legislation.⁴² Furthermore, as more interest groups and political parties gain access to power, the domestic political pressures to accelerate the expansion of the credit supply beyond the confines of prudential standards will increase proportionately. Hence, in order to safeguard the stability of banking system, the government must establish countervailing regulatory guarantees against the corruptive influence of money politics upon legislative institutions. Campaign financing and lobbying initiatives connected to representatives of the banking sector must be strictly monitored and supervised, and there must also be limits upon the movement of former regulatory officials to positions in the private financial sector.

Although the integrity of regulatory institutions can only be preserved if there are limitations upon the pressures that may be exerted by elected officials or dictatorial rulers, a close and clearly defined relationship between the executive branch of government and the public regulator enhances the prestige of regulatory institutions and thereby protects them from corruption. And in fact, the financial regulators of Singapore, Hong Kong, and Taiwan, who preside over three of the world's most stable banking systems, are directly beholden to, and under the direction

considers the possibility that central bankers may not have control over the policy goal but retain independence with regards to the instruments (i.e. short terms interest rates versus monetary quantities) selected to achieve the stated goal. For an overview of variants of central bank independence, see: Bernard, William, *Banking on Reform: Political Parties and Central Bank Independence in the Industrial Democracies*, (Ann Arbor: The University of Michigan Press, 2001), 19-25

⁴² Kroszner, Randall S., "On the Political Economy of Banking and Financial Regulatory Reform in Emerging Markets," (unpublished paper: University of Chicago School of Business, 1998), and, Randall S. Kroszner and Thomas Stratmann, "Interest Group Competition and the Organization of Congress: Theory and Evidence from Financial Services Political Action Committees," *American Economic Review* (forthcoming).

of, the executive branch of their respective governments. Consequently, the formal legal independence of the regulatory agency seems to be far less important for effective financial regulation than the institutional prestige of regulatory officials and the stability of the relationship between regulators and the highest levels of the executive branch.

Another possible solution to the problem of institutional design involves the modulation of the number of distinct regulatory agencies. The power to monitor banks and financial transactions could thus be divided among many institutions, or all regulatory powers may be alternatively delegated to a unified super-institution. However, while each institutional arrangement possesses desirable characteristics, each solution also suffers from potential flaws. For instance, dividing the powers of regulatory intervention would thereby increase the number of active agencies in a single regulatory system. Multiple supervisory institutions can serve as “fire alarms,” which alert government ministries empowered to engage in regulatory intervention to any problems in the banking system. Multiple regulatory agencies can also more effectively notify law enforcement agencies of illegal and fraudulent transactions, and so the greater the number of monitors and agencies with some form of sanctioning power, the less likely that bank managers will engage in risky lending behavior.⁴³ However, a clear line of authority is required for decisive action, as well as for post-crisis accountability, and so the powers of direct intervention and bank closure should more properly lie in the hands of only a few government officials. The officials who administer the multiple regulatory agencies could answer directly to the executive branch, which would then coordinate the activities of the entire regulatory system.

At one institutional extreme, the number of regulatory “veto gates” could be very large (i.e. infinite), which would presumably make any decisive action

⁴³ McCubbins, Mathew D., and Thomas Schwartz, “Congressional Oversight Overlooked: Police Patrols vs. Fire Alarms,” *American Journal of Political Science*, 28, (1984), 165-79

impossible, but would also make regulatory capture impossible. The other end of the institutional spectrum would invest all regulatory authority into the hands of a single public official, which would enhance the decisiveness of regulatory enforcement but would also make regulatory bias more probable. There would then seem to be an institutional trade-off between administrative decisiveness and regulatory incorruptibility.⁴⁴ In summary, there is no clearly “optimal” institutional arrangement that would unconditionally guarantee the stability of a country’s financial sector. Instead, the most that can be done in order to guard the integrity of the regulatory system is to establish multiple channels of accountability, to engage in continuous public scrutiny of the regulator’s job performance, and to devise effective methods of regular and accurate dispersal of information regarding the health of the financial sector. Should these conditions be fulfilled, then even in the case of regulatory failure, the reasons for regulatory dysfunction and financial mismanagement would be much easier to identify and correct.

C. The Social Distribution of Bankruptcy Costs

The full consequences of regulatory action cannot be understood without an empirical analysis of the post-crisis distribution of bankruptcy costs, which are summarized in Table 3.2. In the context of regulatory scenario (1), the costs of bankruptcy are completely absorbed by the taxpayers (i.e. the public treasury). By contrast, in regulatory scenario (2), corrective regulatory intervention forces the bank to increase its level of loan loss reserves, which corresponds to a replenishment of the failed bank’s equity base. Consequently, as part of the corrective regulatory actions

⁴⁴ Cox, Gary W., and Mathew D. McCubbins, “The Institutional Determinants of Economic Policy Outcomes,” In Stephan Haggard and Mathew D. McCubbins, editors: *Presidents, Parliaments, and Policy*, (Cambridge: Cambridge University Press, 2001), 21-63; Cox and McCubbins make a similar point regarding the trade-off between policy credibility and policy decisiveness.

depicted in scenario (2), the costs of bankruptcy are imposed upon the bank manager as well as the bank's minority shareholders. The allocation of bankruptcy costs would then depend completely upon the willingness of the public regulator to initiate regulatory action, which was discussed in the previous section.

According to Table 3.1, in the pre-crisis context, decisions regarding the recapitalization of a distressed bank are formally the prerogative a country's minister of finance, but unfortunately, few developing economies possess a clear framework for resolving bankruptcy claims. Few if any legal provisions exist in most countries that would insure that banks that engage in irresponsible lending would pay the full cost of their misbehavior. Moreover, few countries possess laws that perform the task of "Chapter 11" bankruptcy measures, which would protect a failed bank from its creditors during the rehabilitation phase. Bankruptcy is an extremely rare occurrence in the developing countries, primarily because in relatively small financial sectors, any large firms or banks are "too big to fail," and so, banks are generally not permitted to declare bankruptcy by the government. As a result, public bailouts are the primary method of rehabilitating an illiquid or an insolvent bank, which does little to deter other banks from engaging in risky or irresponsible lending. The credibility of the government's threat to intervene will thus be nullified if the conditions of regulatory scenario (2) are not fulfilled, and without the credible threat of intervention, bank managers will always prefer to behave in a manner that is consistent with regulatory scenario (1).

As indicated by Table 3.1, only a country's prime minister or president can direct the post-crisis resolution process. Only the prime minister or president has the prestige and political authority necessary to force bank managers and corporate executives to bear the costs of bankruptcy and financial rehabilitation. Furthermore, since there is no clear pre-crisis framework for allocating bankruptcy costs in the

post-crisis environment, the executive branch of government must use its constitutionally granted extraordinary powers in order to articulate a new set of institutions which are specifically designed for the purpose of distributing bankruptcy costs equitably. New institutions may include the establishment of bankruptcy courts and legal provisions that would permit minority shareholders and investors to bring suit against delinquent financial institutions. Given the legal ambiguity and political uncertainty that are involved whenever new institutions are developed, the final distribution of bankruptcy costs will inevitably be constrained by the political conflicts that arise during the post-crisis settlement process.

D. Executive Control Rights and Legal Accountability

The credibility of a central bank's threat to intervene into the affairs of a mismanaged bank is also dependent upon the government's ability to re-distribute the rights of executive control, which is the final component of the central bank's decision-making authority. Executive control rights are represented in the model by the bank manager's revenue share, which is re-distributed to the bank's minority shareholders (in the post-crisis context) should the bank manager be found guilty of violating the government's regulatory statutes. Thus, once intervention has occurred, the financial rehabilitation process may introduce new shareholders, who would then exercise their newly acquired rights on the bank's governing board.

The re-distribution of executive control rights occurs in regulatory scenarios (2) and (5), which are summarized in Table 3.2. Control rights are issued in the pre-crisis context by a country's ministry of finance, which along with the central bank makes licensing decisions that control entry into the banking system. The ministry of finance also sets restrictions upon the percentage of a bank's equity that can be

held by a single shareholder. However, in the post-crisis environment, the executive branch must once again use its extraordinary powers in order to terminate the executive position of any delinquent managers. Furthermore, in an autocracy, only the executive branch has the power to permit foreign investors access to the banking sector, and in case of a democracy, the executive branch normally must encourage the legislature to pass new financial legislation that would enable a re-distribution of the executive control rights within the banking system.

Because few developing economies have clearly established laws that would permit the easy re-distribution of executive control rights, the executive branch of government will often engage in a period of institutional innovation during the post-crisis resolution process, in order to create a legal and political framework that facilitates the smooth re-allocation of bank ownership to new shareholders. Given the highly charged and politically contentious nature of post-crisis rehabilitation however, any attempt to re-distribute bank ownership rights or to revoke a bank's license will usually be met with stiff resistance. The political conflicts that are inherent to credit expansion and financial regulation are not limited to the closed economy, and in fact, the distributional problems that plague the government in the closed economy will only be exacerbated by the challenges posed by the open economy.

3.3 Financial Authority in the Open Economy

Once a country opens its banking system to international capital flows, the regulatory authorities that supervise the financial sector must face a new set of difficulties. In terms of the theory of financial authority, the trade-off between monetary policy and banking regulation is extended to the financial environment of

the open economy as a trade-off between a government's exchange rate commitment and a government's regulatory obligations.

Although a full treatment of the relationship between financial regulation and exchange rate management is beyond the scope of this chapter, there seems to be a high correlation between the incidence of banking crisis in the developing economies and the combination of an open capital account and a fixed exchange rate. The distributional conflicts that were explored in the preceding sections can thus be analyzed in the special case of an open economy with a fixed exchange rate regime, which is depicted in Table 3.3 below.

Table 3.3 An Open Capital Account with a Fixed Exchange Rate System

<i>Asset Quality of Banking System</i>		
	<u>Asset (a_0)</u>	<u>Asset (a_1)</u>
	$x_{00} > 0$	$x_{10} = 0$
k_0	Regulatory Failure Political Incentive Asset Market Inflation Over-valued Exchange rate Decline of FX Reserves	Regulatory Discipline (w/Deficit) Politically Neutral Monetary Stability Stable Exchange rate Constant FX Reserves
<i>Bank Capitalization</i>		
	$x_{01} = 0$	$x_{11} < 0$
k_1	Regulatory Discipline Politically Neutral Monetary Stability Stable Exchange rate Constant FX Reserves	Regulatory Prejudice Political Disincentive Asset Market Deflation Under-valued Exchange rate Accumulation of FX reserves

The economic and political implications of the open economy can be divided into four quadrants. The upper left hand quadrant represents the case of unqualified forbearance in the context of the open economy. Because the exchange rate is fixed, domestic constituents can access international credit markets without worrying about exchange rate risk, which makes everyone happy including the government, which presides over a booming economy. The inflow of international credit would then enrich the ruling party's political allies, who gain access to cheap credit, as well as the consumer, who benefits from overall improvement in economic growth. Hence, a fixed exchange rate can magnify the dilemma between a central bank's monetary commitments and the requirements of prudential financial regulation.

The long-term economic consequences of capital inflows are more problematic however. As Table 3.3 indicates, unwarranted forbearance in the context of an open economy causes an expansion of the domestic money supply, ($x_{00} > 0$), which leads to asset price inflation. Furthermore, in accordance with the Mundell-Fleming model of the open economy, the combination of monetary expansion and a fixed exchange rate will cause an over-valuation of the exchange rate. In response, the central bank will be forced to absorb the excess liquidity by purchasing the domestic currency with the central bank's foreign exchange reserves, which depletes those reserves proportionately. Consequently, although the government may gain short run political benefits from practicing forbearance, the uncontrolled expansion of the credit supply will eventually undermine both the exchange rate regime as well as the overall stability of the banking system.⁴⁵

⁴⁵ For a full technical discussion of the application of Mundell-Fleming to the developing economies, see: Jha, Raghbendra., *Macroeconomics for Developing Countries*, (New York: Routledge Press, 1994), Chapters 6 – 9. For a discussion of the effects of uncontrolled credit expansion upon the maintenance of a fixed exchange rate, see: Paul Krugman, "A Model of Balance of Payments Crises," *Journal of Money, Credit, and Banking*, 11 (August, 1979), 311-25

The relationship between the banking sector and the central bank can also become predatory, whereby the government permits capital owners to hold the central bank hostage. Regulatory capture would then allow capital owners to use the central bank's foreign exchange reserves as a form of institutional collateral, in order to leverage their access to international credit. The distributive consequences of such predatory behavior follow from the simple fact that foreign exchange reserves represent the savings of the taxpayers. Hence, the use of foreign exchange reserves as a form of political guarantee allows domestic capital owners to extract a rent from their enhanced access to international capital markets; a condition which was made possible only by their strategic hold upon the central bank's foreign exchange reserves. Furthermore, if multinational lenders declare the equivalent of foreclosure upon a country's banking system, then public savings (i.e. foreign exchange reserves) will be used to bail out domestic banks, thereby magnifying the distributional distortions caused by an open capital account.

By contrast, the upper left quadrant of Table 3.3 represents the case wherein banks are sufficiently capitalized, which leads to economic and political outcomes that differ significantly from the case of unwarranted forbearance. When the banking sector holds high quality assets and is sufficiently capitalized, the rate of credit expansion is constant ($x_{10} = 0$), which also leads to stable asset prices and has no negative effects for the management of the fixed exchange rate. Similarly, monetary stability would result if the banking sector holds poor quality assets but is well capitalized, ($x_{01} = 0$). In fact, the only substantive difference between the case of ($x_{10} = 0$), and the case of ($x_{01} = 0$), is that in the latter case, the government is forced to bear the costs of the banking system's balance sheet deficits, $(a_0 + k_0) \leq 0$, which was a consequences of regulatory scenario (2). Politically however, monetary stability may not be popular among the government's domestic constituents, who would prefer

a credit boom and all of the benefits that would ensue. Domestic constituents may then lobby the government to permit the banking sector to reduce its level of capitalization ($x_{00} > 0$), which would lead to the consequences depicted in the upper right hand quadrant.

The final permutation of the open economy framework is depicted in the lower right hand quadrant of Table 3.3. In an open economy with a fixed exchange rate, if the government decelerates the rate of credit expansion, ($x_{11} < 0$), then the consequences would be deflationary for the asset market, and furthermore, the nominal exchange rate would become under-valued. In response, the central bank would have to accumulate foreign exchange reserves (i.e. sell the domestic currency) and thereby expand the domestic money supply in order to reverse the movement of the exchange rate. Politically, the deflationary effects would make the government's policy extremely unpopular domestically, and so enormous political pressures would be brought to bear in order to re-expand the credit supply. Such economic and political dynamics are typical of countries that are involved in I.M.F. stabilization programs.⁴⁶ In particular, countries that initiate stabilization policies, in which the exchange rate is used as a nominal anchor, are vulnerable to the economic and political pressures described in the deceleration scenario. Finally, countries that have experienced a banking crisis would also fall into the deceleration category, and must unfortunately face both the demands of the I.M.F. as well as the political pressures anticipated by the open economy extension of the model.

The theory of financial authority has generated a set of specific expectations regarding the empirical relationship between monetary policy and banking regulation. In a closed economy, expanding the credit supply in order to selectively benefit a

⁴⁶ Haggard, Stephan and Robert Kaufman, "The Politics of Stabilization and Structural Adjustment," In *Developing Country Debt and the World Economy*, edited by Jeffrey D. Sachs, (Chicago: University of Chicago Press); Henry S. Bienen and Mark Gersovitz, "Economic Stabilization, Conditionality, and Political Stability," *International Organization*, 39, 4, (Autumn, 1995), 729-54

government's political constituents will undermine the solvency of the banking system. At a micro-level, in a poorly regulated credit market, bank managers can benefit privately by engaging in self-loans or related party loans, but minority shareholders will suffer as a result of the bank manager's predatory lending policy. Furthermore, if regulators tolerate poorly managed banks in order to accelerate the domestic credit supply, then taxpayers must be willing to bear the costs of bankruptcy. Hence, an acceleration of the rate of credit expansion generates private benefits for bank managers and for the government's political constituents, but forces the public treasury and the bank's minority shareholders to bear the costs of the government's credit policy.

By contrast, if the government adopts a policy of credit deceleration, the banking sector must maintain a level of capitalization that is so high as to be suboptimal, in that overcapitalization slows the rate of credit expansion, the costs of which must be borne by the government's political constituents. Furthermore, in the case of credit deceleration, the bank's minority shareholders benefit from the higher level of capitalization imposed by the credit limitations, but the bank manager makes only moderate income compared to the credit acceleration scenario.

Alternatively, if the government adopts policies that maintain a constant rate of credit expansion, the associated regulatory action would reduce private benefits for bank managers and eliminates any preferential credit that is received by the government's constituents. However, preserving a steady state of credit expansion guarantees the solvency of the banking system and protects the rights of minority shareholders. Regulators can maintain a stable credit policy either by inducing bank managers to self-select the appropriate level of capitalization, or by intervening in the affairs of bank managers who fail to abide by the central bank's prescribed capitalization levels. In the case of intervention, the public regulator must allocate

the costs and benefits of prompt corrective action. When the regulator intervenes in the case of credit acceleration, the rate of credit expansion stabilizes, but the government's constituents lose their access to selective credit allocation and the bank manager loses their revenue, which is redistributed to the bank's minority shareholders. By contrast, if the central bank intervenes in the case of credit deceleration, the rate of credit expansion returns to the steady state, but the bank manager would lose their income and the minority shareholders would receive a lower return on their investment.

Once a country opens its credit market to international capital flows, the distributional conflict observed in the closed economy case is extended to the dilemmas imposed by the open economy. In particular, the public regulator will now face a trade-off between preserving the solvency of the banking system, with all of the distributional implications observed in the case of the closed economy, and modulating the rate of credit expansion, which has its own inevitable distributional consequences. In the worst case, the attempts to simultaneously protect a fixed exchange rate and practice regulatory forbearance towards a deteriorating banking system will undermine both the exchange rate regime and the ultimate health of the banking system.

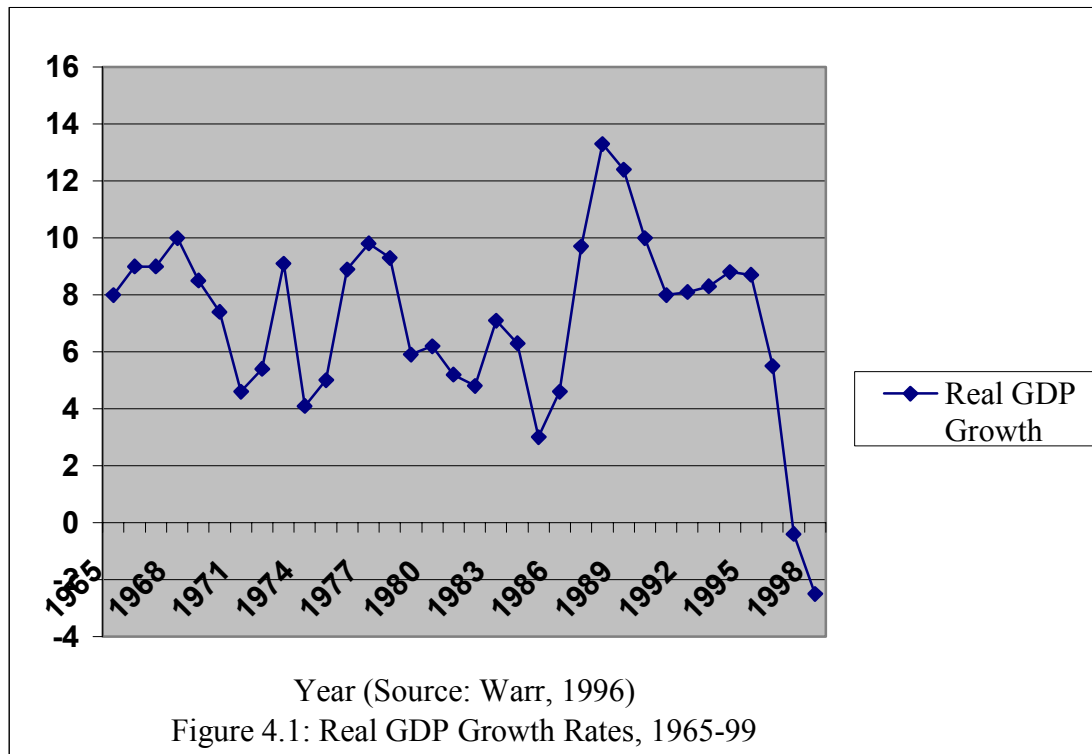
Chapter 4

The Realm of Capital

Credit Cycles and Social Conflict in the Kingdom of Thailand

I. Introduction

Over the past half century, Thailand has experienced a series of boom-bust cycles, wherein periods of accelerated economic growth are followed by extended periods of financial crisis. As illustrated in Figure 4.1, in the 1960s and 1970s, Thailand experienced a period of economic expansion that was followed by a system-wide financial crisis in the 1980s. In the 1990s, Thailand once again experienced a period of economic boom, only to face an even more severe crisis in 1997.



The prevailing explanations for the clearly observable cyclical pattern can be grouped into two categories. Arguments in the first category explain domestic economic outcomes in terms of geo-strategic events, including the occurrence of regional wars and international price or credit shocks, and arguments of the second

category are institutional, and revolve around capture of the central bank by local capitalists, which allegedly contributed to the occurrence of the Asian financial crisis. To these dominant approaches, I have added the theory of distributional conflict, which hypothesizes that conflict over control of the banking sector is significant for explaining the cyclical patterns of Thailand's economic history.

The competing explanations for the cyclical pattern of Thailand's development are detailed in Table 4.1. As illustrated in Table 4.1, Thailand's dynamic geo-strategic position has always informed the formulation of its domestic economic policies. The financial sector was created in the early 20th century in large part in order to strengthen Thailand's position relative to its regional competitors and relative to the dominant European banks. Geo-strategic realities intruded once again during WWII, when the Japanese seized Thailand. The Japanese imposed their control upon Thailand's monetary system by tying the Thai currency to the yen-gold standard, and it was further under Japanese auspices that the Bank of Thailand was founded in 1942.

The national security imperative was resurrected as Thailand's development strategy between 1957 and 1973, during which Thailand was governed by three distinct military regimes. The primary strategic goal of the military regimes was to strengthen Thailand's alliance with the United States, and this required that the regime crushing any domestic political resistance to their pro-American policies. While socially repressive, Thailand's geo-strategic alliance with the United States had an important financial dimension that took the form of American aid and investment in the 1950s and 1960s, as well as America's assistance in the development of a modern system of financial regulation.

Table 4.1: Competing Theories of Financial Crisis in Thailand

	<u>Economic Outcome</u>	<u>Geo-strategic Shocks</u>	<u>C.B. Independence</u>	<u>Distributional Conflict</u>
1919-22	Financial Crisis	Sliver Price Shock	N.A.	Monarchic Government
1940-45	Financial Stability	Japanese Occupation	BoT established (1942)	Japanese monetary controls Thai banking collaboration
1945-57	Financial Stability	Cold War U.S. aid-investment	BoT Act (1942) MoF and Crown	Military Regimes Sino-Thai Banks Established
1958-78	Financial Boom Oil Shock (1973)	Vietnam War BoT powers expanded	Comm. Bank Act (1962) Military-Industrial	Military Coups (1957, 1962) OligarchyFinancial Repression
1979-88	Financial Crisis	2 nd Oil Shock (1979)	Comm. Bank Act (1986) “Life-Boat” (1986-88)	Quasi-Democracy Rise of Business Oligarchy Regulatory Discipline
1989-96	Financial Boom	Global Financial Liberalization	BoT Act (1992)	Oligarchic Democracy Banking Sector Ascendant Boom-Bust Cycle
1997-99	Financial Crisis	Global Financial Crisis	BoT Act (1998)	Oligarchic Democracy Fiscal Deficits Criminal Prosecutions

Exogenous geo-strategic shocks have also precipitated economic instability. When the Vietnam War ended for instance, the exit of American forces in 1973 precipitated a wave of capital flight that forced the devaluation of the Thai baht. Furthermore, Thailand endured a second set of crises following the oil shocks of 1973 and 1979. The oil shocks not only caused the fiscal and trade deficits of the late 1970s but undoubtedly contributed to the bank failures of the mid-1980s. .

Electoral and regulatory reforms of the 1980s and 1990s also had an effect upon the growth and stability of Thailand's banking system. Most importantly, the financial and political liberalization that occurred in the 1980s played an obvious role in explaining the rise of the business oligarchy that still dominates Thailand's political system. Theories of institutional reform and interest group formation have also been used to explain central bank failure in the 1990s, during which the central bank lost control of domestic financial markets. These arguments presume that it was the regulatory capture of the Bank of Thailand by business-dominated political parties caused the financial turmoil of 1997.

While both geo-strategic and institution based arguments identify possible causes of banking crisis, they also suffer from obvious deficiencies. Theories based upon external events presume that the government has little control over its own economy, and sociological theories do not specify any precise mechanism for explaining how interest groups cause a financial crisis. In order to redress these theoretical shortcomings, another strand of institutionalism focuses upon the agency problem between the Prime Minister's office and the central bank. In this case, the prime minister may desire banking stability, but he may be unable to control the central bank governor, who could conceal information about the health of the banking sector from the country's political leadership.

As mentioned in chapter one, this argument presumes that the prime minister is naïve and often innocent of wrongdoing and that the central bank has complete control over the banking sector. Because this argument conceives of the central bank as a dictator over the banking sector, this point of view is unable to conceive of a possibility that bank managers can contradict the regulatory policies announced by the central bank. In other words, institutionalism overlooks the relationship between financial regulators and bank managers, which lies at the heart of the financial system.

Without insuring that banks will actually adopt the announced regulatory policy however, there is no way to insure the long-term credibility of prudential regulatory standards. Furthermore, it is a fact that the reforms that followed the 1997 crisis contained no amendments to the relationship between the prime minister's office and the central bank, which would be expected had the pre-crisis relationship between the political leadership and the central bank been somehow fundamentally flawed.

As an alternative approach, I have proposed that financial regulation should be understood as a contractual negotiation between the central bank and bank managers, over the social distribution of the costs and benefits of regulatory actions. This model is based upon the intuition that exogenous shifts in regulatory policy have distinct and measurable monetary and fiscal consequences. Because of the distributional consequences of financial regulation, I have hypothesized that regulatory actions create incentives for conflict to emerge between bank managers, shareholders and taxpayers. According to this view, the cyclical pattern of Thai economic development can be explained by the often violent and politically calamitous struggle over the control of regulatory policies. Finally, I discuss the possibility that conflict over regulatory policy may be endemic to the financial system, and so there may be

no optimal institutional configuration that can insure the stability of regulatory outcomes over time.

Empirically, even the cursory evidence presented in Table 4.1 supports the view that each phase of Thailand's economic history corresponds to a distinct distributional configuration, that often included the military and the Crown, that regulated the banking system and controlled access to the credit market. Finally, the distributional approach suggests that financial stability is possible only if regulatory actions distribute the costs and benefits generated by the banking sector equitably among the members of society. While no institutional arrangement can guarantee the equitable allocation of costs and benefits, dictatorial systems are no worse than democratic systems in this regard.

4.2 Credit Cycles and Social Conflict

My primary hypothesis is that the cycles of Thailand's financial history are the result of often-violent and politically calamitous conflict over control of the banking system. Accordingly, and as depicted in Table 4.2, I propose that we explain regulatory outcomes as the result of a negotiation -between the central bank and bank managers over the social distribution of the monetary and fiscal externalities generated by the banking system. We should then be able to resolve Thailand's economic history into distinct regulatory phases, depicted above in Table 4.2.

Table 4.2: The Distribution of the Costs and Benefits of Regulatory Action in Thailand, 1900-2004

<u>Regulatory Scenario</u>	<u>Bank Status</u>	<u>Regulatory Action</u>	<u>Economic Outcome</u>	<u>Taxpayers</u>	<u>Bank Managers</u>	<u>Shareholders</u>
(1) 1919-22	Bankrupt	NA	Financial Deflation	Budget Deficit	Crown Properties collects rents	NA
(2) 1940-45	Solvent	Forbear	Stable Markets	Surplus (1940-45)	Japanese collect rents from 4 Thai banks	
(3) 1945-57	Wealthy	Intervene*	Stabilization	Regulatory Cost	Crown, Generals	Sino-Thai families and Bureaucrats
(4) 1958-78	Wealthy	Forbear	Financial Repression	American fiscal support	Sino-Thai shareholders	Military Rents
(5) 1979-86	Bankrupt	Forbear	Boom-Bust Cycle	Budget Deficit	Sino-Thai ascendant	Lifeboat Bailouts
(6) 1988-97	Bankrupt	Forbear	Boom-Bust Cycle	Surplus (1990-95) Deficit (1996-97)	Super-profits	Asset Deflation
(7) 1998-2002	Bankrupt	Intervene	Stabilization	Deficit (1998-02) Surplus (2002-04)	Limited Prosecution	Re-capitalization Foreign Owners

Accordingly, I have applied the hypothetical scenarios describe in Table 4.2 to a narrative description of Thailand's financial history. Between 1932 and 1973, Thailand was governed by succession of regimes, dominated by the monarchy, the military, and ambitious bureaucrats. At the heart of the conflict for power, was Thailand's nascent financial system. While the monarchy and Chinese merchants provided the seed-capital for Thailand's largest commercial banks, it was the nationalist revolutionaries and the military officers who held ultimate authority over the banking sector.

Regulatory Prejudice: Between 1932 and 1973, the banking system was a source of contention between the monarchy, the military and Chinese merchants because it provided rents to whoever controlled the allocation of credit. Rents were created by financial repression, which meant that deposit rates were kept artificially low, and loan rates were higher than rates available in the advanced financial markets. Financial repression thereby imposed artificial limits upon commercial bank lending, and created rents that were distributed between the Chinese merchant class, the monarchy, and the military.

Thailand's security alliance with U.S. also enhanced its role as regional financial center. American financial assistance heavily subsidized Thailand's military budget, which reduced pressure upon Thai banks to provide credit to the various branches of the Thai military. Within this capital friendly environment, the Sino-Thai families who owned the banking system were able to negotiate relatively conservative lending policies, and as a result Thailand experienced relatively few bankruptcies. The regulatory consensus negotiated between the Chinese merchant families, the military and the bureaucracy was enforced through a variety of institutional mechanisms, including the central bank, the finance ministry, the Budget Bureau, and other government agencies that maintained tight controls upon the banking sector.

Consequently, while the military regimes that governed Thailand from 1945 to 1973 repressed the financial sector artificially, they also provided commercial banks with an environment that permitted them to extend their influence to every sector of the Thai economy. Thus, while the era of financial repression created an opportunity for corruption and rent seeking by the bureaucracy and the military, the extension of commercial banks to all economic sectors provided the basis for the economic boom of the 1960s and early 1970s.

Regulatory Failure: Between the late 1970s and late 1990s, Thailand experienced boom-bust cycles, wherein periods of inflation were followed by periods of financial devastation. For instance, during the late 1970s, Thailand was still governed by a military regime that preferred financial stability to high rates of financial growth. Consequently, although Thailand maintained a fixed exchange rate regime, the government limited foreign capital flows to foreign direct investment, and foreign bank lending was largely restricted to the government-sponsored agricultural sector and export oriented manufacturing industries.

The late 1980s witnessed a period of political and financial liberalization that opened Thailand's political system to full fledged involvement of private businesses and opened Thailand's financial system to foreign participation. Foreign banks were attracted to Thailand's high growth rates as well as the stability of the exchange value of Thai assets on international markets, and the stability of asset values was in turn dependent upon the fixed exchange rate regime.

The link between credit inflows and the stable currency meant that the exchange rate functioned as a distributive mechanism, permitting foreign bankers to diversify their asset portfolios by lending to a market they believed would remain stable.

Furthermore, the relationship with foreign banks allowed Thai commercial banks to leverage and expand their position in the domestic economy. As a result, when foreign banks became heavily exposed to the Thai economy, both the Thai business

community and the central bank became convinced that the sudden exit of foreign banks from Thailand would collapse the entire economy. Thus, when the credit-induced economic boom began in the early 1990s, there was nothing the central bank could do but re-double its efforts to protect the exchange rate.

During both the 1970s and the 1990s, the central bank and bureaucracy tolerated high levels of financial growth and questionable lending practices, which inevitably caused the bankruptcy of several banks and financial institutions. The central bank effectively traded off short-term credit-driven economic expansion for long-term debt that resulted from the failure of several firms and financial institutions. Despite several rounds of financial sector reforms and the strengthening of the regulatory system, the 1990s witnessed an even more dramatic period of credit-driven growth that benefited bank managers and majority shareholders, but created fiscal and financial burdens that were ultimately born by taxpayers and the public, in the form of expanding fiscal deficits, higher interest rates on commercial bank loans, and a deterioration in public services for the general population.

Regulatory Discipline: Regulatory intervention followed the financial crises of the mid-1980s and late 1990s. The crisis of the mid-1980s caused the collapse of several financial companies and forced regulatory authorities to temporarily suspend operations within two major commercial banks. Although the post-crisis reform process in the 1980s empowered the central bank to replace delinquent managers, but few punitive measures were imposed upon poorly managed financial institutions. Instead the government initiated a massive bailout program that helped bank re-capitalize and thereby temporarily supported minority shareholders. The government's rehabilitation program may have benefited bank managers, but it did little to protect depositors or the taxpayers, who were forced to tolerate heightened fiscal deficits that lasted well into the early 1990s. This pattern of bailout for bank managers paid for by higher fiscal deficits and higher interest rates was

repeated in the late 1990s following the even more devastating financial crisis of 1997. In fact, throughout the 1990s, the government provided support for troubled financial institutions without replacing or penalizing the bank managers who oversaw the period of indiscriminate lending. Following the crisis, the pattern of taxpayer sponsored bailouts continued and only a few of the bank managers and CEOs involved in criminal activity were actually brought to justice.

4.3: Social Conflict and the Bank of Thailand

At the beginning of the 20th century, Thailand was one of the few countries in South East Asia that avoided occupation by a European empire. Because European banks still dominated global finance, political independence could only be guaranteed by a preservation of monetary autonomy, and it was for this reason that Thailand's first banks were founded. The period between 1932 and 1973, provides a great deal of evidence for the importance of geopolitical events and distributional politics for the development of Thailand's financial system, but provides little evidence for the importance of bureaucratic independence for maintaining the stability of the financial system.

Due to the instability of domestic and regional politics, Thai banks have had to adapt to periods of monarchic absolutism (1904-32), nationalist paternalism (1932-40), Japanese imperial occupation, (1940-45), as well as a series of military dictatorships (1947-73). During each of these eras, political necessity determined the size and functions of the financial system, and institutional developments, such as the establishment of the Bank of Thailand in 1942, were a function of the balance of political power between the monarchy, the military and outside forces, rather than economic rationality or the requirements of institutional autonomy. For instance, Thailand's first banks were founded during the era of monarchic absolutism, between

1904 and 1932, when there was little banking regulation beyond the controls imposed by the financial advisors of King Rama IV. The lax controls on royal spending benefited members of the royal family and the military, but also generated enormous public deficits.

The fiscal and financial profligacy of the monarchy brought Thailand to the brink of bankruptcy and fuelled discontent amongst nationalist reformers and dissatisfied members of the military. Within this uncertain environment, a revolution was staged in 1932 that brought left-leaning bureaucrats to power. The reign of the technocrats proved to be short-lived and in 1938, a military putsch brought the first of many army cliques to power. Military spending rose to one third of the national budget, and Thailand launched an expansionist military policy in the northeast in an attempt to bring parts of Cambodia and Laos under Thai control.

The end of world war two brought a series of increasingly pro-American military governments to power. And it was during the era of pro-American military governments between 1947 and 1973, that the majority of Thailand's modern commercial banks were founded. Thus, while Siam Commercial Bank was founded in 1904, the Bank of Asia would not be founded until 1945, and what were to become Thailand's largest banks, Bangkok Bank, Bangkok Metropolitan Bank, and the Union Bank of Bangkok would not be established until the 1950s.

The nationalists, who governed Thailand between 1932 and 1938 and again between 1945 and 1947, also established many bureaucratic channels that enabled them to strictly control the lending practices of domestic commercial banks. These institutions included the National Banking Bureau (founded in 1939), which under Japanese auspices was transformed into the Bank of Thailand in 1942.⁴⁷ The

⁴⁷ Richard Doner and Ansil Ramsay, "Competitive Clientelism and Economic Governance: The Case of Thailand," in Sylvia Maxfield and Ben Ross Schneider, eds. *Business and State in Developing Countries*, (Ithaca: Cornell University Press, 1998), 260; Phongpaichit and Baker, *Thailand: Economy and Politics*, 121

Nationalist Party's control of the banking system depended less upon formal bureaucratic channels than upon direct government representation on the executive boards of Thailand's largest banks, as well as the largest public and private firms. Thus, twenty-seven members of the governing People's Party appeared regularly upon the executive registries of twenty-seven of Thailand's largest state-owned firms, as well as on the board of directors of several of Thailand's largest private Chinese owned firms.⁴⁸

The restrained credit policies followed by the government during the 1950s and 1960s stand in direct contradiction to the notion that the lack of bureaucratic independence necessarily leads to expansive and inflationary credit policies. Thus, contrary to the bureaucratic independence model, the Bank of Thailand and state bureaucracy was of only secondary importance to the initial phase of Thailand's financial development.

Between 1947 and 1973, Thailand was governed by a series of U.S. supported military regimes, led by the Rachakhru faction (1947-57), General Sarit (1957-63), and General Thanom (1963-73). Although Thailand had declared war against the United States during WWII, the Americans quickly forgave any wartime infractions and built a long-term strategic relationship with Thailand. America's strategic partnership with Thailand grew out of both governments' concerns over the communist victory in Mainland China (1949), the Malayan communist insurgency (1950), the beginning of Korean War (1950) and French losses in Vietnam (1954). Furthermore, by January 1950, Ho Chi Minh had seized power in Hanoi with the support of both Moscow and Beijing. In response to these communist victories, American strategists articulated the "domino theory", which justified American intervention in the South East Asia. As a consequence, in 1952, Dwight Eisenhower announced his intent to increase the flow of resourced to anti communist governments

⁴⁸ Phongpaichit and Baker, *Thailand: Economy and Politics*, 121-122

in South East Asia, and Thailand quickly became a chief beneficiary of American financial and military support.⁴⁹

Thailand's alliance with the U.S. was reflected in Thailand's conservative economic policies, but this was only possible because of a formation of a distributive coalition between Thailand's capitalists and the military. Thus, while geo-strategic factors and domestic distributional considerations played an obvious role in how the domestic financial system was governed, there is little evidence that bureaucratic independence was even an issue for either the Americans or the Thai military.

Many have praised this period as an era of conservative economic policies during which the banking system remained under the stringent controls imposed by a largely autonomous central bank.⁵⁰ However, as illustrated in Figure 4.1, this perspective overlooks the fact that it was during this era of "bureaucratic autonomy" that bank ownership became even more concentrated in the hands of a few Chinese families, and that it was also during this period of time when the Thai business sector became intimately connected to the leadership of the Thai military.⁵¹

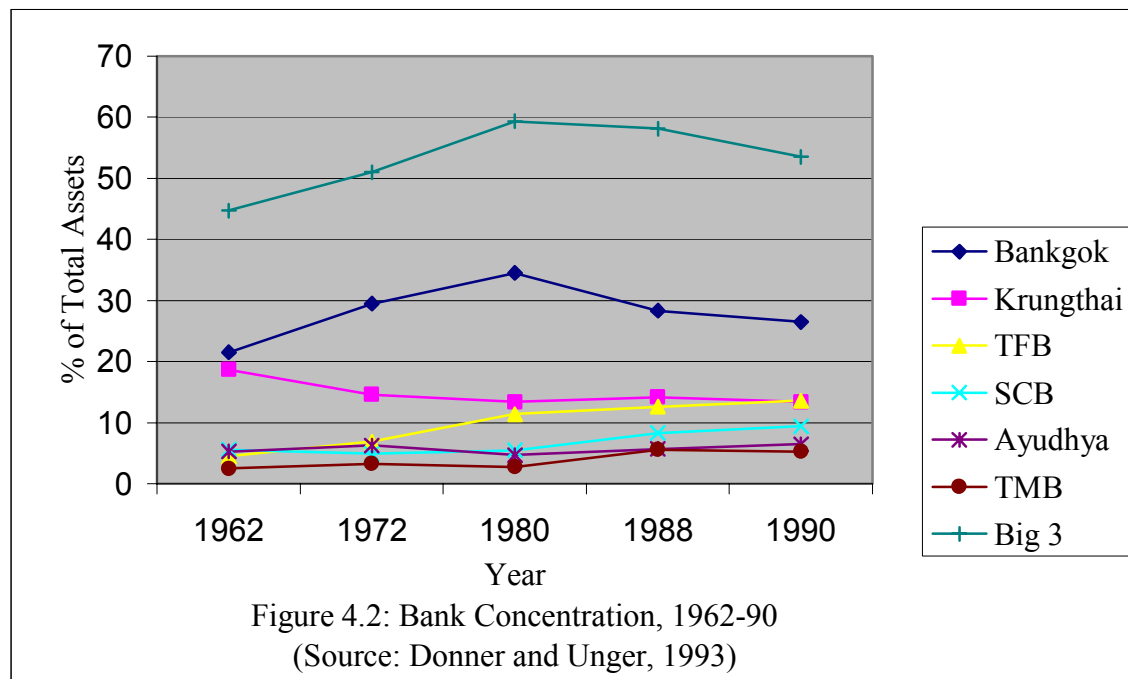
Thus, despite the neo-liberal pretensions of the Thai government during this period, the banking system increasingly came under control of a small number of Chinese

⁴⁹ Between 1965 and 1968, the police force increased from 51,000 to 80,000 men. According to one estimate, half of all US economic aid between 1965-69 was channeled to the police force. (pg. 277). Air force was modernized. From 1951 to 1972, total US military assistance reached 1.15 billion (average of \$52 million) or 54 percent of the total defense budget. Thai defense budget went from \$20 million in the early 1950s to \$250 million per year in the early 1970s. Over two decades, the total military budget increased seventeen times. (pg. 277). Between 1976 and 1982, the Thai defense budget expanded from \$484 million to \$1.5 billion and reached \$2.7 billion by 1990. (pg. 331).

⁵⁰ The civilian bureaucracy grew from 75,000 in 1944 to 250,000 in 1965. The number of government departments increased from 49 in 1941 to 113 in 1969, and the number of divisions from 317 to 827. (pg. 288)

⁵¹ Between 1964 and 1968, the Sophonpanich family nearly doubled its ownership shares of Bangkok Bank from 17 percent to 32 percent. Similarly, between 1945 and 1970, the Lamsam family increased its ownership shares of Thai Farmer's Bank from 22 percent to 58 percent; between 1964 and 1972, the Ratanarak group increased their shares of Bank of Ayudhya from 26 percent to 43 percent; and finally, between 1950 and 1979, the Tejapaibul family increased its control of Bangkok Metropolitan bank from 11 percent to 44 percent. (Muscat, 115) The banking families control over the banking sector was further consolidated in 1962, when the Ministry of Finance declared a moratorium on the issuance of any further banking licenses, which permitted Thailand's four largest private commercial banks (Bangkok Bank, Thai Farmers Bank, Bank Ayudhya, and Bangkok Metropolitan Bank) to increase their share of total deposits from 33 percent in 1962 to 49 percent of total deposits in 1979. (Muscat, pg. 116)

families, who as a result of their close contacts with the Thai military, were allowed to create vast industrial conglomerate networks that were centered on the banking industry.



The bank-dominated corporate governance model that prevails in Thailand presumes close monitoring of the banking industry by regulatory officials and requires that the government exercise a high degree of public authority over the governing boards of the major banks. The first source of the government's authority over the banking sector is statutory. Beginning with the Bank of Thailand Act of 1942, the Thai government promulgated a set of laws that defined both the formal purview of government officials as well as the rights of bank shareholders and managers.⁵²

⁵² The statutory powers of the Bank of Thailand are augmented by the informal powers of co-optation and moral suasion. By exerting informal pressure, the Bank of Thailand can shape the incentives facing the governing boards of commercial banks without taking official action.

4.3 The Bank of Thailand and Crisis Management

Between 1979 and 1986, Thailand experienced a set of financial problems that in many ways anticipated the 1997 crisis. Thailand's difficulties began with the oil shock of 1979. The oil shortage led to a deterioration of the trade balance and accumulation of foreign debt, and Thailand entered a period of economic stabilization and adjustment programs under the supervision of the IMF. The expanded demands of the semi-democratic governments also brought pressures to bear upon the central bank. Under semi-democracy, central bank officials could not adjust to the oil shocks of the 1970s by de-linking the baht from the dollar. The Bank of Thailand was also required to provide preferential credits to government related industries.⁵³

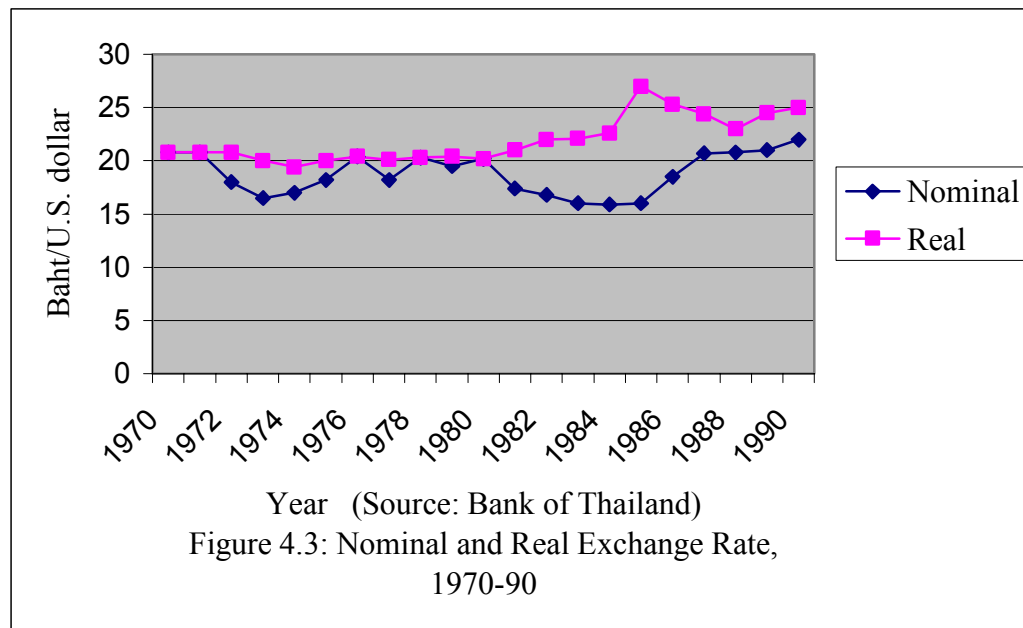
The combination of government credit activism and price controls yielded interest rates that were significantly negative or near zero between 1973 and 1978 although the credit supply expanded at 20 percent a year. Due to the commercial code's limits on nominal rates, the central bank had little ability to increase lending rates, which raised the prospect of capital outflows and lower rates of domestic savings. The absence of regulatory constraints upon the rapid growth of finance companies also led to unchecked stock manipulations, insider trading, and illicit loans. At the center of the financial problems was the Raja Finance Company, which offered credits to its affiliates in order to manipulate the stock price of finance companies. The failure of Raja Finance triggered the collapse of the Securities and Exchange of Thailand in 1978 and the failure of a major finance company the following year.⁵⁴

The financial crisis of 1979 helped undermine the democratic government to the extent that the military was able to re-assert its political dominance. The Prem government (1980-1988) remained in power by managing the differences between the

⁵³ Doner and Unger, *The Politics of Finance in Developing Countries*, 111

⁵⁴ Doner and Unger *The Politics of Finance in Developing Countries.*, 111-113; Pakorn Vichyanond, *Financial Reforms in Thailand* (Bangkok: TDRI, 2000), 7

military and the political parties. Prem further weakened the influence of the political parties upon economic policy by reducing the supply of preferential credit and strengthened the power of government bureaucrats over domestic banks. Prem distributed economic posts in the cabinet according to technocratic expertise and eschewed filling top bureaucratic positions with members of parliament.



The economic recession was succeeded by a more severe financial crisis starting in October 1983. The crisis was triggered by large losses of a financial company and its affiliates. The financial crisis in 1983-86 affected one-third of all financial institutions, which accounted for one-fourth of all financial assets. The crisis was further aggravated by the ongoing recession and tight monetary policies that brought to the surface management flaws inherent in the banking sector as well as in the less well-governed finance companies. Anticipating the 1997 crisis in many ways, the financial crisis was accompanied by a deterioration of the external account and resulted in the devaluation of the baht by 14.8 percent in November 1984. The

underlying causes of the 1983 financial crisis were “weak management policies, notably the extension of credit and guarantees to businesses with which the bank directors and shareholders were involved, and an over-concentration of lending to a few large scale and inter-related industries.”⁵⁵

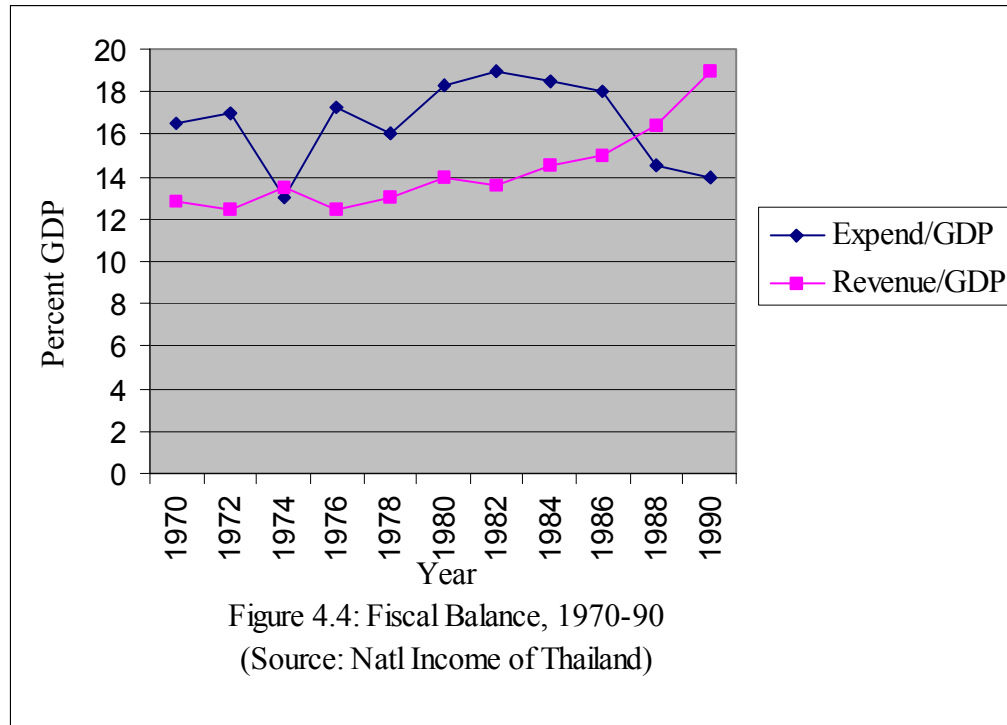
The financial crisis of 1983-86 caused the failure of 15 finance companies and forced the government to inject liquidity into 32 other companies through the “lifeboat” plan that was announced in April 1984. The lifeboat plan was administered by the newly established Fund for the Rehabilitation and Development of Financial Institutions, which received interest free contributions from the five largest banks as well as from all other major financial institutions. As a result of the crisis, three commercial banks faced financial difficulties for which they were later investigated and up to 20 finance companies had their license revoked.⁵⁶

As illustrated in Figure 4.4 below, and as predicted by the model presented in chapter two, these failures deepened Thailand’s fiscal deficit, which became more pronounced as the result of public bailouts. In the aftermath of the 1983 crisis the central bank led the effort to impose new regulations regarding cash reserves as well as stricter requirements for branch expansions and minimum contributions to the government sponsored rehabilitation funds. In 1985, the Commercial Banking Act was once again amended to empower central bank officials “to enforce compliance with regulations through direct intervention, to order an increase in bank capital, and to remove bank directors and officers when deemed necessary in the public interest.”⁵⁷

⁵⁵ Robinson, David, et al. Thailand: Adjusting to Success, Current Policy Issues (Washington: IMF, 1991), 22

⁵⁶ Laurids S. Lauridsen, Thailand: Causes, Conduct, Consequences, In: Jomo K.S., editor: *Tigers in Trouble: Financial Governance, Liberalization and Crisis in East Asia* (London: Zed Books, 1998), 141; Vichyanond, *Financial Reforms in Thailand: Structure and Liberalization*, (Bangkok, TDRI, 1994), 7. In 1984, Asia Trust Bank faced the specter of rising NPLs because the bank had overextended credit to affiliated firms. In 1986, First Bangkok City Bank sustained losses from the foreign currency market, and in 1987 Siam City Bank was investigated for imprudent loans to provincial areas. Finance companies that had their licenses revoked included Raja Finance (1978), Thanakit Credit Fonciers (1982), and Patana Finance Company (1983).

⁵⁷ Doner and Unger, *The Politics of Finance in Developing Countries*, 116



The Bank of Thailand Act was also amended and new legislation was passed in order to give government officials new tools with which to manage troubled financial companies.⁵⁸ The 1985 legislation granted the Bank of Thailand the authority to conduct on-site examinations and permitted the central bank to remove incompetent bank officers as well as to restrict any transactions between troubled institutions and their directors. The amendments also allowed the central bank to bring suit against the shareholders of financial institutions, a measure that targeted irresponsible board members for the first time.⁵⁹

It is often claimed that the Bank of Thailand reached its highest position relative to the other branches of government during the Prem era, and so the period between 1980 and 1988 is appropriately referred to as the “golden age” of bureaucratic

⁵⁸ Other legislation includes: “The Act on the Undertaking of Finance Business”, and the “Securities Business and Credit Foncier Business Act”.

⁵⁹ Pakorn Vichyanond, *Thailand's Financial System*, 32; and, Doner and Unger, *The Politics of Finance in Developing Countries*, 116.

autonomy and prestige.⁶⁰ However, in fact, the center of macroeconomic decision-making gravitated between the Bank of Thailand and the Ministry of Finance; as well as the NESDB, the Budget Bureau, and the Fiscal Policy Office. And so, even during the so-called golden age, the Bank of Thailand was only one many bureaucratic instruments for controlling the banking sector. The military still figured prominently in bank management, both because of the existence of the Thai Military Bank and because several officers retained their positions on the governing boards of many commercial banks. Thus, the demarcation between the 1980s, when the Bank of Thailand is thought to have enjoyed the highest degree of bureaucratic independence, and the era of the 1990s, when the central bank was supposedly “captured” by the banking sector is largely a fiction, since the central bank actually wielded more power in the 1990s, then at any other time in its bureaucratic history.

4.33 Credit Cycles and Social Conflict in the Open Economy

During the last two decades of the 20th century, the relationship between the political and financial systems in Thailand changed dramatically. In the 1980s, Thailand was transformed from a bureaucratic polity to a semi-democracy (*prachathippatai khru'ng bai*), which evolved into a multiparty parliamentary democracy in the 1990s. As Table 4.1 in the appendix demonstrates, every government formed after the 1978 electoral reforms has been a multiparty coalition. The 1978 constitution organized the Thai electorate into multi-member constituencies, which encouraged the formation of multiparty coalition governments within Parliament. The regional distribution of the Thai electorate is also significant, in that 80 percent of electoral districts are rural. The dominance of the rural districts in the

⁶⁰ Allen Hicken, *The Politics of Economic Reform in Thailand: Compromise and Crisis*, (Unpublished Paper, January 2003), 16.

electorate has elevated political entrepreneurs from the provinces to a leading position in the Thai parliament.⁶¹

Coalition politics in Thailand is by no means a simple function of geography however, since rural constituencies do not always vote according to party loyalty.⁶² Rural electors barter their vote with the politician or party that can most effectively funnel the largest portion of the national budget towards the province. Party discipline is also weak, and as a result, 38 percent of MPs have switched party affiliation at least once between 1980 and 1997.⁶³ As a consequence, every coalition government formed since 1988 has been a highly unstable alliance of provincial notables, Bangkok businessmen, and special interests, such as the military. And by the 1990s, the penetration of Thai business networks into the political realm was so complete well over half of all members of the Thai parliament were somehow connected to the contracting, real estate, or banking industries.⁶⁴

The Chatichai government (1988-1991) can best be described as a semi-democracy. Although the Chatichai government was formed under military auspices, the new government initiated a set of political reforms that enabled the cabinet to wrest control of key bureaucracies away from the military. Under Chatichai, the NESDB, the Budget Bureau and the Bank of Thailand came under the control of a multi-party coalition, and thus, many bureaucratic powers formerly held by these institutions were delegated away to individual ministries. Ministerial portfolios were

⁶¹ Anek Laothamatas, *Business Associations and the New Political Economy of Thailand: From Bureaucratic Polity to Liberal Corporatism* (Boulder: Westview Press, 1992), 45; Baker and Phongpaichit, *Thailand: Economy and Politics*, 348; Philip Robertson, "The Rise of the Rural Network Politician: Will Thailand's New Elite Endure?" *Asian Survey*, Vol. 36, No. 9 (September 1996), 937

⁶² Suchit Bunbongkarn, "Elections and Democratization," in R.H. Taylor ed. *The Politics of Elections in Southeast Asia* (Washington, D.C.: Woodrow Wilson School Center Press, 1996), 190

⁶³ Chengtian Kuo, *New Financial Politics in Taiwan, Thailand and Malaysia*, Unpublished Paper (National Cheng Chi University, 1999), 39-41

⁶⁴ Paul Handley, "More of the Same? Politics and Business, 1987-96," In Kevin Hewison, ed. *Political Change in Thailand: Democracy and Participation* (New York: Routledge, 1997), 106
The Thai Rak Thai party (led by business tycoon Thaksin Shinawatra), the Social Action party, Chuan Leekpai's Democrats, the New Aspiration Party (with close relations with the notorious Bangkok Bank of Commerce), Chat Thai, and the Chat Pattana party were all well known to have intimate business and financial links.

also distributed according to the logic of coalition building and maintenance rather than professional qualifications. The erosion of bureaucratic autonomy accelerated following the civil disturbances of 1991 and the constitutional reform of 1992, when the military was finally compelled to relinquish any claim to government. Following the 1992 reforms, the position of Minister of Finance, and by extension, the Governor of the Central Bank, became political appointments allocated by whichever party dominated the ruling coalition.⁶⁵

Simultaneous to the political reforms of the 1980s and 1990s, the economic bureaucracy initiated a series of financial and banking sector reforms that were meant to transform Thailand into a regional financial center. Building upon interest rate reform that Thai authorities initiated in the late 1980s, in May 1991, Thailand accepted the terms of IMF's Article VIII that required lifting foreign exchange controls on current account transactions.⁶⁶ In April 1991, Thailand moved to remove most restrictions upon capital account transactions as well. During the third round of financial sector reforms in February 1994, Thai authorities liberalized outward direct investment and various forms of cross-border payments.⁶⁷ The centerpiece of Thai financial reforms was the establishment of the Bangkok International Banking Facilities (BIBF) in March 1993. The BIBF was intended to facilitate global financial transactions, thereby making Thailand a regional competitor to Hong Kong and Singapore.

In retrospect, it is difficult to appreciate the exuberance with which Thai businessmen met the government's plans to open the financial sector. Within a few years Thailand was awash in easy international credit, and instead of serving as a

⁶⁵ Hicken, *The Politics of Economic Reform*, 16; Phongpaichit and Baker, *Thailand: Economy and Politics*, 355-360

⁶⁶ Pakorn Vichyanond, *Financial Reforms in Thailand* (Bangkok: Thailand Development Research Institute, 2000), 8. Interest rate ceilings on long term time deposits were abolished in June 1989, on short term time deposits in March 1990, on savings deposits in January 1992, and on loan rates in June 1992

⁶⁷ endorsed by the Central Bank Governor in letter. No. 545/2533, which also contains plans to commit to the terms of IMF's Article VIII.

center for internationally oriented (out-out) transactions, the BIBF served as the main conduit for foreign capital (out-in transactions) seeking high rates of return from the fastest growing of the “emerging markets.” In one year, from 1993 to 1994, credit inflows jumped from zero to an average of 350 billion baht (\$12 billion). In 1995, net foreign inflows jumped another 69 percent, which implied that more money flowed into Thailand during 1995 than during the entire decade of the 1980s. In all, between 1993 and 1997, a total of \$68 billion flowed into Thailand through the BIBF, and by mid-1997, Thailand’s total external debt had reached \$92 billion.⁶⁸

The financial reforms required that by 1993, domestic banks adopt capital reserve requirements consistent with the recommendation of the Bank of International Settlements (BIS).⁶⁹ Otherwise, the reforms said little about how banks should adapt to the managerial and staffing pressures that would inevitably follow financial opening. Thus when Thailand was inundated with credit, Thai banks were ill prepared to productively channel the quantity of financial flows coming in through the BIBF. At the height of the capital deluge in 1995, the largest commercial banks had only recently begun to develop techniques of modern risk management and relied instead upon the good name of the borrower and upon whatever collateral was offered as a security.

Major decisions regarding credit allocation by each bank were the responsibility of the board of governors. But the governing boards of Thai banks had no experience with managing credit flows at the level witnessed in the 1990s. At best, governing board members who were inexperienced with allocating such large sums of credit made decisions that led to a higher rate of non-performing loans (NPLs). At worst, as in the case of the Bangkok Bank of Commerce and Finance One Plc

⁶⁸ Pasuk Phongpaichit and Chris Baker, *Thailand's Boom and Bust* (ChagMai: Silkworm Books, 1998), 100.

⁶⁹ The 1988 BIS standards specify an 8 percent capital-asset ratio which consists of 4 percent tier 1 capital and 4 percent of tier 2 capital. Implicit in the BIS standards is a risk weight to each type of financial transaction in which depository institutions engage.

(formerly Thailand's largest finance company), board members colluded with management to embezzle billions of baht from their respective financial institutions. And when public regulators tried to hold managers accountable, members of three successive coalition cabinets intervened to protect their business allies from gaze of regulatory scrutiny.

As domestic banks struggled to manage capital inflows, the new political entrepreneurs were counting upon the Bank of Thailand to maintain the status quo; a booming economy characterized by easy access to credit and a stable exchange rate. Both politicians and businessmen alike understood that the linchpin of Thailand's rapid economic expansion was the fixed exchange rate, and so enormous pressures were exerted, from both within as well as from without the Bank of Thailand, in order to insure that the exchange rate system would remain unaltered. Given the magnitude of capital flows entering the country however, the credit expansion imperative came into conflict with the regulatory responsibility of the Bank of Thailand.

As capital flows accelerated in 1995, fiscal and monetary policy, to the extent that they were effective, were both wielded to support the exchange rate regime. But when capital flows continued unabated, the Bank of Thailand committed the fatal error of employing regulatory forbearance to support the exchange rate system. Because of monetary and political constraints, the Bank of Thailand seemed to treat poorly managed banks and finance companies with unlimited tolerance. The policy of unqualified forbearance was supported by an authority structure within the Bank of Thailand that encouraged secrecy and made policy coordination between the different departments difficult. Accordingly, when the financial sector continued to deteriorate, the Bank of Thailand organized a massive bail-out program, wherein billions of baht in public funds were used to bail out troubled banks and finance companies without replacing delinquent managers and without implementing policies to ensure that those found guilty of wrongdoing would face personal liability for their misbehavior.

The Bank of Thailand was forced into the unenviable position of supporting a politically induced, but economically unsustainable level of moral hazard. A succession of governments that came to power in the 1990s sacrificed the requirements of banking regulation in order to maintain their access to international credit and in order to preserve the fixed exchange rate system that was the key to the intricate web of alliances between politicians and businessmen. And because financial institutions provided political parties with such a rich source of easy credit and campaign financing, the coalition governments that came to power did so with a mandate of protecting the banking sector from aggressive interventions by public regulators. The Bank of Thailand was thus held hostage, and was forced to exert all of the authority that it had accumulated over decades of responsible economic management in order to protect the fixed exchange rate regime. In other words, the Bank of Thailand was forced to pursue a policy of credibility at all costs. By undermining the soundness of the banking sector however, the unstable coalitions that vied for political power brought down the entire financial system as well as the fixed exchange rate regime that they had so desperately wanted to preserve, ushering Thailand into an era of unprecedented crisis.

4.31 Governing Banks: The Credit Expansion Imperative

In 1992, Chuan Leekpai and the Democrats came to power, leading a coalition government consisting of five parties. Chuan became prime minister with a popular mandate to consolidate democratic reforms and to promote economic liberalization. Chuan's main backers were Bangkok businessmen, who heavily influenced his cabinet appointments. In the critical post of finance minister, Chuan selected Tarrin Nimmanhaeminda, a former banker and an important member of the pro-business BMS political lobby. And as central bank governor, Chuan selected Vijit Supinit, who

was well known to be friendly with many Thai bank managers. One of Chuan's chief financial backers was also appointed as minister of construction, whose enormous budget made him one of the most important men in Thailand.

Under Chuan, who became known in the popular media as "Mr. Whitewash", extensive financial sector reforms were carried out and the BIBF was established.⁷⁰ Indeed, Chuan's choices for finance minister, central bank governor, as well as the economic reform platform that he adopted, sent a strong signal to the financial community that Thailand had entered a period of rapid financial liberalization. In response, and as depicted in Figure 4.5 below, the banking sector initiated the greatest expansion of credit ever witnessed in Thailand's history.

The effect of the credit boom upon Thailand's business community was instant and profound, but relative to their size, the property sector and stock market were by far the greatest beneficiaries from the capital bonanza. The number of golf courses and other recreational facilities increased from a meager 10 courses in the 1980s to over 250 during the 1990s, and the number of upper end real estate projects expanded twenty-fold.⁷¹ The stock market index spiked from 600 following the 1991 coup to a stellar 1750 by January 1994 and the P/E ratio went from sixteen in 1992 to twenty-six and thirty in 1993.

However, the high concentration of stock transactions in the financial sector (57 percent of all transactions) and the property and telecom sectors (22 percent) meant that any bad news about these sectors of the Thai economy could result in a stock market crash.⁷² In percentage terms, the largest portion of the international capital came in the form of credit flows and so bank and finance company lending

⁷⁰ Interview by author, Bangkok, September 2000, see also: Pasuk Phongpaichit and Chris Baker, *Thailand's Boom and Bust*, 252-53

⁷¹ Interview by author, Bangkok Thailand, July 2000

⁷² Phongpaichit and Baker, *Thailand: Economy and Politics*, 101

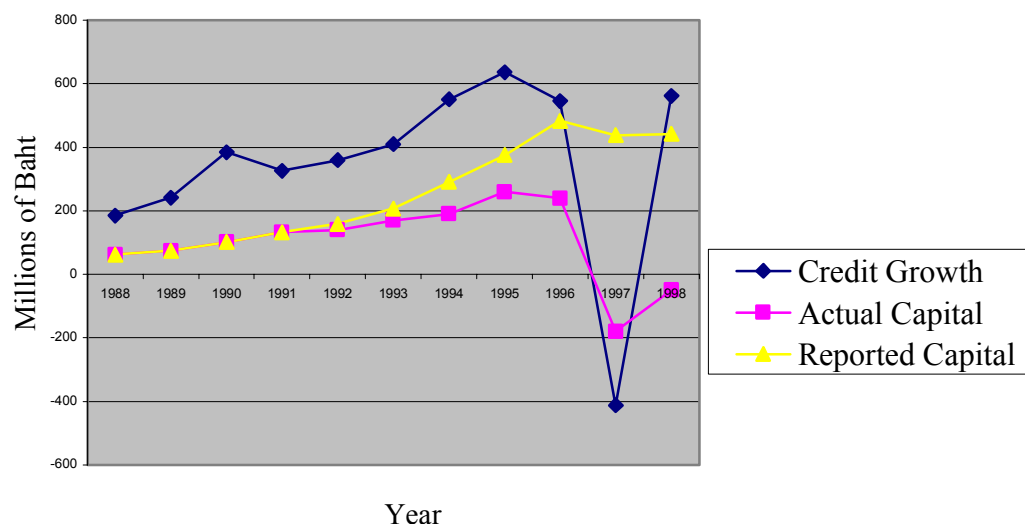


Figure 4.5: Bank Governance in Thailand
(Krung Thai Bank Research Department)

comprised approximately 60 percent of all corporate financing meant that corporate financing was skewed towards debt, yielding high debt/equity ratios.⁷³ Given the type and volume of capital inflows, the risk assessment and management capabilities of Thai banks became crucial for maintaining continued economic growth and financial stability.

Prior to the crisis, Thai commercial banks operated with only primitive models of risk management. The only effective check upon imprudent lending by the Thai banks was the authority and integrity of each bank's board of governors. As Table 4.2 in the appendix details, within Krung Thai Bank, Thai Farmers Bank and Siam Commercial Bank, which are among Thailand's largest banks, loans above the Bt 500 - Bt 1 billion level can only be extended with the approval of the board of governors. Among medium sized banks such as Bank Ayudhya, Thai Military Bank and the Bangkok Bank of Commerce, loans above the Bt 250 - Bt 500 million range required

⁷³ In 1995, bank lending totaled Bt 837.6 million, while finance companies lending totaled Bt 286.2 million; and total corporate lending in 1995 equaled Bt 1.58 billion.

the approval of the board of governors. Internally, private banks adopted and required semi-annual or annual performance reviews for loan officers and all bank department managers. The government banks, by way of contrast, put little faith in performance incentives or performance related reviews.⁷⁴

According to interviews conducted at 6 Thai commercial banks and 3 finance companies, the dominant risk management strategy prior to the crisis was to allocate capital according to: 1) The reputation of the client, 2) the existence of a personal relationship between the loan applicant and the bank manager, and 3) the value of any collateral offered as a security. Each of these methods of managing risk suffers from deficiencies, which in a closed economy, can lead to bankruptcy. But in an open economy confronting the additional risks associated with capital inflows, adopting an inadequate model of risk management can have disastrous systemic consequences.

Loan officers within commercial banks are well versed in the importance of credit analysis and in other technical methods, such as expected cash flow analysis. Yet within most banks, loan officers and branch managers could only approve loans within the Bt 10 million to Bt 25 million range. The largest loans were the province of the board of governors, who make their decisions based upon many other factors beyond formal credit analysis. For instance, Thai banks participated in large syndicated loans to high profile industrial projects, so that credit risk could be distributed among a large number of banks. Loans to Siam Cement, the Sahara City

⁷⁴ Interviews by author, Bangkok Thailand, June-August, 2000

Table 4.3: Management Survey of Thai Commercial Banks

	<u>Ayudhya Bank</u>	<u>Siam Commercial Bank</u>	<u>Krung Thai Bank</u>
Owner	Ratanarak family	Crown Properties Bureau	Ministry of Finance
Political Connections	Democrats	Democrats/BMS	Government Bank
Criminal Activity	Negligible	Negligible	Negligible
NPLs	6.02% prior to crisis 14% reported after crisis 16% property exposure 0.43 written off in 1997 0.88% written off in 1998	6.9% prior to crisis 11.69% reported after crisis 14% property exposure 2.19% written off in 1997 9.98% written off in 1998	10.3% prior to crisis 21.57% post-crisis 40-60% actual NPLs 0.80 written off in 1997 3.03% written off in 1998
Performance Requirement	Yes Semi-annual review (3 strikes policy)	Yes Annual review Loosely enforced prior to crisis After crisis 2,000 were retired After crisis performance standards strictly enforced	None

Table 4.3: (continued)

	<u>Ayudhya Bank</u>	<u>Siam Commercial Bank</u>	<u>Krung Thai Bank</u>
Risk Management	No Risk Dept. pre-crisis Established in 1998	No Risk Dept. prior to crisis Established in 1999 (VAR) J.P. Morgan VAR	No Risk Dept. pre-crisis Established 1998 J.P. Morgan VAR
	2 Credit Risk teams 2 Market Risk teams	25 Risk Assessment Personnel 2 Credit Risk team 1 Market Risk team 1 Information Tech. Risk team	30 Risk Assessment Personnel 3 Credit Risk teams 2 Market Risk teams 2 Intl. Market Risk teams
Loan Management	4 Credit Committees 3 Exec. board members on each committee Provincial manager approval Bt 55-60 million Exec. Committee approval for Bt 500 million – 1 billion Board of Gov. approval for Bt 1 billion loan	1,000+ Loan Officers 2 Credit Committees Exec VP approval for Bt 500,000 SVP approval for Bt 1 million Presidential approval for Bt 50 million Exec. Committee approval for Bt 100-500 million loan Board of Governors approval for Bt 500 million and above	1,500+ Loan Officers 5 Credit Committees Senior VP approval for Bt 1 million loan Exec. VP approval for Bt 5 million Presidential approval for Bt 10 million Exec. Committee approval for Bt 100 million loan Board of Governors' approval for Bt 1 billion

Table 4.3: (continued)

	Thai Farmers Bank	Thai Military Bank	Bangkok Bank of Commerce
Owner	Lamsam Family	Government	Jalichandra
Political Connection		Government Bank	Chart Thai Chart Pattana “Group 16”
Criminal Activity	Negligible	Negligible	Sia Song (CFO) accused of fraud Krik Jalichandra (Chairman) and Rakesh Saxena implicated in widespread securities fraud
NPLs	7.4% prior to crisis 17.3% post-crisis 12% property exposure 0.73% written off in 1997 23.11% written off in 1998	9.3% prior to crisis 20.3% post-crisis 17.3% property exposure 4.57% written off in 1997 11.7% written off in 1998	18.09% prior to crisis 33.51% reported post-crisis 12% property exposure 67.08% written off in 1997 Closed in 1998

Table 4.3: (continued)

	<u>Thai Farmers Bank</u>	<u>Thai Military Bank</u>	<u>Bangkok Bank of Commerce</u>
Performance Requirements	Annual Review Retirement program accelerated post-crisis	None	None
Risk Management	No formal risk- management department prior to crisis	No formal risk- management department prior to crisis	No formal risk- management department prior to crisis
Loan Management	Bank Manager approval for loans below Bt 5 million Board of Governors approval for loans over Bt 500 million	Bank Manager approval for loans between	Governing Board approval for loans over Bt 100 million

(Source: Krung Thai Research Department, TISCO Research Department, and bank interviews, June-August, 2000)

resort, or the Bangkok Monorail project were not only considered relatively safe, but improved the standing of the lending institution.⁷⁵

Loan syndication did manage to distribute risk among Thailand's largest financial institutions, but involvement in huge projects also had the effect of concentrating loan portfolios. Prior to the crisis, Thailand's second largest bank (Krung Thai Bank) was involved in a series of syndicated loans to 10 industrial groups that totaled 48 percent of the KTB's loan portfolio.⁷⁶ On average, government officials have estimated that prior to the crisis, the top 10 percent of each bank's portfolio constituted up to 50 percent of the value of the entire loan portfolio.⁷⁷

The second weakness of pre-crisis risk management was the willingness of Thai banks to accept real estate as the primary form of collateral. The widespread use of property as collateral made the real estate market a source of instant wealth. In principal, real estate valuation is a highly subjective process, and in the environment of a financial boom, property can be easily over-valued. The over-valuation of real estate prices not only inflated asset prices, but made it much more difficult for the central bank to estimate the true risk exposure of Thai financial institutions. Because property values were skyrocketing, there was little hesitation about extending loans to clients who offered real estate as collateral. In case of foreclosure, banks optimistically believed that loans secured by property would be easier to recover. For these reasons, financial institutions had loan portfolios that were concentrated in a few high profile mega-projects and that were exposed to the property market to an extent far greater than suggested by official statistics.

The data on bank lending indicates that the majority of BIBF mediated loans went to large manufacturers such as the Siam Cement Company, and to loans for

⁷⁵ Interviews by author, Bangkok Thailand, June-August, 2000

⁷⁶ *The White Paper*, (Bangkok: Krung Thai Bank Research Department, April 1999)

⁷⁷ Interview by author, Bangkok Thailand, July 2000

commercial transactions, and to inter-bank facilities. Official BIBF statistics state that only 3-4 percent of incoming capital flows were directed towards the property market. The aggregate BIBF figures are misleading for two reasons. First, a significant proportion of loans received through the BIBF were re-lent by corporate conglomerates to subsidiaries active in the property market and second, since much of the collateral provided by manufacturers and exporters was in the form of real estate, true BIBF exposure to the property market was at least 20 - 30 percent and private estimates range up to 50 percent.⁷⁸ If finance companies are included, the level of exposure rises, due to the fact that the exposure of some financial companies to the property market reached levels as high as 80 percent.⁷⁹

The third defect in the risk management policies of Thai banks was a heavy reliance upon “relationship loans.” The term “relationship loans” is used to cover three categories of credit: 1) loans extended to a bank manager’s personal acquaintances, 2) loans to affiliated firms, and 3) loans extended to major shareholders or members of the board of governors. The Bank of Thailand made few efforts prior to financial liberalization to curb relationship loans to the extent that the central bank did not require banks to submit consolidated financial statements; a measure that would have forced banks to disclose additional information regarding loans to affiliated parties.⁸⁰

⁷⁸ Interview by author, Bangkok Thailand, July 2000 and private interview, August 2000

⁷⁹ Interviews by author, various finance companies, Bangkok July – September 2000; TISCO Research Department, Bangkok, August 2000

⁸⁰ Interview by author, Bangkok Thailand, August 2000

Table 4.4: Estimated Value of Relationship Loans (as a percentage of total loans) ⁸¹

Loans based upon personal contacts:	≥ 50 percent
Loans to affiliated firms:	≥ 20 percent
Loans to shareholders:	
Large Banks	< 5 percent
Medium Sized Banks	10 – 12 percent ⁸²
Small Banks	10 – 15 percent
Large Finance Companies	15 – 20 percent ⁸³
Smaller Finance Companies	≥ 60 percent

The actual percentage of “relationship loans” is hard to estimate but it is perhaps the most important indicator of risk exposure. Unofficial estimates of the magnitude of various types of relationship loans are displayed in Table 4.4. The estimates imply that the most prominent type of relationship loans was credit extended to business allies or personal acquaintances of bank managers. If true, these figures mean that formal risk assessment methods played only a minor role in determining the allocation of credit.

Although government officials ceased holding positions on the governing boards of Thai banks by the 1980s, the principle of extending loans to affiliated parties survived the process of corporate governance reform. Relationship loans continued into the era of capital flows because loans to affiliated parties compensated for a bank’s inability to fully assess the future profitability of a project and so allowed

⁸¹ Interview by author, Bank of Thailand, Banking Supervision Department, August 2000; Interview by author, TISCO Research Department, Bangkok Thailand, July 2000; Interviews, various banks and finance companies, July - September 2000.

These figures are calculated as percentage value of the total loan portfolio that is extended upon the basis of personal relations, loans to subsidiary firms and loans to shareholders and Executive Board members.

⁸² The loan range for Medium sized banks does not include the BBC, which is reported to have up to 90 percent loans to shareholders and to friends of the management.

⁸³ Estimate does not include the funds that were allegedly embezzled by the management of Finance One Plc.

Thai banks to channel capital without changing their governance model or risk assessment methodology. Thai banks operate in an environment where only 40 percent of firms that receive credit submit statements of account as part of their loan applications. In such an information-poor credit market, the governing boards of Thai banks continued to rely heavily upon loans to personal acquaintances, loans to subsidiary firms and loans to shareholders as a way of managing the uncertainty of the credit market.

Loans to subsidiary firms were the second most prominent type of relationship loan. Loans to related firms became an important way for Thai banks to erase non-performing loans off of their balance sheets without having to adjust their capital reserves or equity levels. Bad loans could be transferred to the balance sheet of a subsidiary firm while the parent firm would remain solvent. The Bank of Thailand was poorly informed about the extent of loans to subsidiary firms because prior to the crisis the central bank did not require consolidated balance sheets that would alert public supervisors to this type of financial transfer.

Loans to shareholders were the least prominent type of relationship loans. The Bank of Thailand imposed a 5 percent limit upon loans to shareholders in 1979, but there were many ways to get around the legal limitations. The primary difficulty with enforcing the legal limitations was the prevalence of “nominee accounts”; which are bank accounts registered under a false name.⁸⁴ Through similar accounting techniques, loans to shareholders could be obscured from regulatory scrutiny. Consequently, every category of financial institution displayed in Table 4.2 extended loans to shareholders beyond the legally prescribed limit.

The fourth inadequacy of the pre-crisis risk management strategy was the use of short-term liabilities to finance balance sheet deficits. By 1995, short term debt held

⁸⁴ Pedro Alba, et. al., *Thailand's Corporate Finance and Governance Structures: Impact on Firms' Competitiveness* (Washington, D.C.: World Bank, 1999), 2-3

by Thais had reached \$41.1 billion, which accounted for half of the country's total external debt. Banks held \$33.7 billion in short-term debt, which accounted for 82 percent of total external short-term liabilities. Moreover, \$23.7 billion (70 percent) of total short term debt came from the BIBF.⁸⁵ Of all firms with foreign currency denominated debt, only 19 percent hedged their exposure and only 12 Thai firms in total fully hedged their foreign currency debt.⁸⁶ Exposure of the banking sector to such high levels of short-term debt meant that if any doubts were to emerge regarding the health of the financial sector, Thailand's access to international credit markets would quickly evaporate.

No matter how poor the risk management strategies adopted by commercial banks, Thai banks managers were far more prudent than their counterparts in finance companies. According to managers at three of Thailand's more successful financial companies, the finance company sector was essentially indifferent to issues of risk management.⁸⁷ Finance companies were deeply involved in the financial crises of 1979 and 1983 and in fact, some of the companies that were rescued in 1983 failed once again in 1997. The central bank's primary method of regulating the finance companies was by restricting their activities, such as forbidding non-bank financial institutions from taking deposits. But finance companies circumvented government regulations by offering promissory notes to the public on terms identical to that of interest bearing bank accounts.⁸⁸

⁸⁵ "Analysing Thailand's Short-Term Debt," Economic Research Department, Bank of Thailand Economic Research Department, *Bank of Thailand Economic Focus*, Vol. 1, No. 3, July-September 1996, 11

⁸⁶ David Dollar and Mary Hallward-Driemeier, "Crisis, Adjustment, and Reform in Thailand's Industrial Firms", in *The World Bank Research Observer*, Vol. 15, No. 1 (Washington D.C.: World Bank, 2000), 12

⁸⁷ Interviews by author, Bangkok, June-August, 2000. One of these companies was temporarily closed during the pre-crisis panic in July-August 1997.

⁸⁸ "Asset Price Inflation: Developments and Policy Issues", *Bank of Thailand Economic Focus*, Vol. 2, No. 1, Economic Research Department (Bangkok: Bank of Thailand, 1998), 15

The tactic of accepting promissory notes permitted finance companies to act as banks without having to adopt the equity and capital reserves levels that were required for all deposit taking institutions. Access to short term international financing and the mimicking of commercial banks allowed the finance companies to expand aggressively. With such easy access to funds the finance companies were seemingly fearless, constituting 60 percent of the total exposure to the property sector. Aggressive expansion of the finance companies without adequate regulatory controls led to a 300 percent growth rate in non-bank financial sector between 1992 and 1997.⁸⁹

The final source of institutional risk was fraud, which is inherently difficult to estimate and is never included in official statistics. According to the personal interviews from which Table 4.3 was constructed, except in the extreme case of smaller finance companies, the Bangkok Bank of Commerce, and Finance One Plc., loans to board members were the least significant category of relationship loans. A full discussion of fraud is included in section 4.6, but with regards to systemic risk, the consequences of financial fraud may have had a greater impact upon more reputable banks and finance institutions than any other single factor of the pre-crisis period. The most prominent case of financial fraud is that of the Bangkok Bank of Commerce (BBC), whose failure in 1996 was the culmination of six or seven years of conspiracy by the board of governors and managing directors to embezzle funds from the bank and to engage in a variety of illegal money making schemes. Another form of fraud was the case of “strategic NPLs” which is a term adopted by Thai regulators to describe the looting of a bank’s balance sheet that occurred when bank managers realized that financial crisis was inevitable. As a defensive measure, and beginning in late 1996, Thai bank managers began moving an average of 15 percent their most

⁸⁹ *World Economic Outlook*, (Washington, D.C.: International Monetary Fund, March 1998)

valuable assets overseas, so as to protect the largest shareholders from bankruptcy settlement claims in the future.⁹⁰

BBC may have been the most serious case of financial distress, but that bank was not the only casualty of the years of easy credit. Prior to the crisis, in 1994, corporate profits for the average firm listed on the Stock Exchange of Thailand (SET) were 5.78 times higher than average interest expenses. But by the end of 1995, the ratio of profits to interest expenses fell to 4.01, and fell further to 3.11 at the end of 1996. Just prior to the crisis, in mid-1997, profit-interest ratios reached a dismal 1.49. Thus, by the end of 1997, two thirds of all corporate profits went to cover interests from corporate loans.⁹¹

As profit ratios fell, the number of firms that were illiquid or technically bankrupt rose proportionately. The number of firms that could not cover the interest expenses rose from 18 in 1994 to 114 in early 1997, implying that by 1997 interest repayment became impossible for over one third (36.4 percent) of loans outstanding to listed corporations.⁹² The failure of so many Thai banks and companies was the consequence of a combination of factors, but as illustrated above, the manner in which banks governed their risk exposure was of critical importance. However, the fact that Thai banks were so ill prepared for the managerial pressures of the open economy begs the question of why the Bank of Thailand failed to initiate bank level managerial reforms at an earlier phase of financial liberalization.

⁹⁰ Interviews by author, Bangkok Thailand, June-August, 2000

⁹¹ Pedro Alba, *Thailand's Corporate Finance and Governance Structures*, 2-3

⁹² Pedro Alba, *Thailand's Corporate Finance and Governance Structures*, 3

4.32 The Bank of Thailand Divided: Monetary Policy and Banking Regulation

Financial liberalization imposed new political and economic constraints upon the Bank of Thailand. Every ruling coalition knew the importance of preserving the exchange rate regime, both for economic growth as well as for maintaining political popularity. The arcane world of banking regulation and supervision however, was comparatively less well understood by the political establishment. Neither did Thai politicians fully envision the consequences of adopting a policy of unwarranted regulatory forbearance within the context of an open economy. Hence, any policies that could alter the fixed exchange rate regime, such as aggressive intervention into the financial sector or the relaxation of the fixed exchange rate system, were simply out of the question politically. Conflict was then inevitable, between those who wanted to take corrective measures against the banking sector and those who were willing to gamble upon the Bank of Thailand's ability to support the exchange rate regime, whatever the regulatory consequences.

The parliamentary democracy of the 1990s increased pressure upon the Bank of Thailand to adopt a regulatory posture that was viewed as "business friendly." During the stable years of the Prem era (1980-1988) for instance, there were only three finance ministers appointed by the prime minister. The following decade of coalition democracy (1988 to 1998) by contrast, saw the appointment of thirteen finance ministers.⁹³ Within the new political environment, the central bank felt obliged to respond to whichever finance minister was appointed by the ruling coalition. Through the ministry of finance, the prime minister and his cabinet could subtly influence the policy stance of the central bank, particularly with respect to its regulatory posture. Furthermore, during episodes of parliamentary infighting, the

⁹³ Hickens, *The Politics of Economic Reform*, 16

Bank of Thailand came under attack from opposition MPs who wanted to undermine the governing coalition by attacking the central bank. As a result, the Bank of Thailand became much more sensitive to political pressure than at any other time in its history.

The first problem for the Bank of Thailand came as a result of the volume and maturity of the debt flows that entered Thailand through the BIBF. By 1995, central bank officials realized that the high rate of capital inflows and the accumulation of short term debt threatened the stability of the monetary system. Effective sterilization was impossible, both due to the sheer magnitude of the capital inflows and because the thin bond repurchasing market provided authorities with little means of monetary adjustment. To mitigate the inflationary effects of capital inflows upon asset prices, the Bank of Thailand decided to impose a 7 percent reserve requirement upon BIBF transactions, as well as upon non-resident baht accounts and short-term finance company loans. The central bank also adopted a policy of “interest rate smoothing” whereby incremental adjustments in the short-term interest rate were made in order to reduce the volatility of prices, but without affecting the overall upward trend.⁹⁴ Yet concern over the effects of so much foreign capital entering the banking system persisted to the extent that for the first time since 1984, the Bank of Thailand considered the prospect of abandoning the fixed exchange rate system.⁹⁵

In December 1995, any plans to relax the exchange rate system were overwhelmed by the global consequences of the Mexican peso crisis. And it was during the defense of the baht in late 1995 that, for the first time, the Exchange Equalization Fund (EEF) and the Banking Department employed swap transactions, and in fact, the Bank of Thailand’s success at playing the swap market ensured the

⁹⁴ Interview by author, Bank of Thailand, Bangkok Thailand, July 2000

⁹⁵ *The Nukul Commission Report: Analysis and Evaluation on Fact Behind Thailand’s Economic Crisis*, (Bangkok: The Nation, 1998), 32-35

survival of the baht peg.⁹⁶ While some within the central bank raised further concerns regarding the viability of the fixed exchange rate, Deputy Governor Chaipayat Wibulswasdi overrode dissenting voices, pointing out that the Bank of Thailand had demonstrated that it could successfully defend the baht. Chaipayat also argued that any alteration of the system could result in a visitation of the Mexican experience upon Thailand.⁹⁷

Deputy Governor Chaipayat's confidence may have seemed reasonable in 1995, but the Bank of Thailand's exchange rate strategy proved ultimately to be inconsistent with the regulatory policies adopted by the three coalition governments who held power between 1992 and 1997. The potential for conflict within the Bank of Thailand can be illustrated in Figure 4.5 below, which represents a simplification of the central bank's internal organization.

The pre-1997 Bank of Thailand consisted of six divisions, two of which were responsible for supporting the exchange rate; the Exchange Equalization Fund (EEF), headed by Deputy Governor Chaipayat Wibulswasdi, and the Banking Department, which was headed by Director Bandid Nijathaworn.⁹⁸ The EEF was responsible for selling or buying the amount of baht necessary to maintain the spot exchange rate within the announced exchange rate band (Bt 25 to 1 U.S. dollar). The Banking Department by contrast, was responsible for any significant foreign exchange interventions carried out by the central bank. Conflict and lack of coordination between the EEF and Banking Department was to prove crucial in the failure of the fixed exchange rate in July 1997.

Financial supervision by the Bank of Thailand was carried out by the Bank Examination Department and the Financial Institutions Supervision Department,

⁹⁶ *The Nukul Commission Report*, 29

⁹⁷ Interviews by author, Bangkok, July-August 2000

⁹⁸ *The Nukul Commission Report*, 59

which were under the authority of Deputy Governor Jaroong Nihawoon. The examination and supervision departments were critical because the central bank governor made decisions regarding regulatory intervention conditioned upon the information collected by financial examiners. The political importance of the central bank's supervision capacity extended to the Ministry of Finance and the Prime Minister's Office, who depended heavily upon Bank of Thailand in order to gauge the overall health of the financial system

Effective financial supervision during the 1990s was stifled in two ways. First, the central bank governor concealed embarrassing revelations about the banking sector. The central bank's tendency towards secrecy only exacerbated the difficulties associated with accurately estimating the health of domestic financial institutions. Banks and finance companies were also wary of providing supervisors with a full accounting of their risk exposures. Given that 40 percent of firms receiving credit did not even submit statement accounts, even the financial institutions could not have full knowledge of their own risk exposures.⁹⁹

The extra operating and credit risks associated with the open economy, relationship lending, and the dominant collateral patterns meant that Bank of Thailand supervisors systematically over-estimated the capitalization levels of domestic banks and finance companies. When queried regarding the BBC affair, the financial examiners at the Bank of Thailand staunchly defended themselves, arguing that examiners had warned the Bank of Thailand leadership as early as 1992 that the BBC was technically bankrupt. In response to similar queries about the finance company sector and Finance One in particular, the financial examiners were less certain, and

⁹⁹ Dollar and Hallward-Driemeier, "Crisis, Adjustment and Reform in Thailand's Industrial Firms," 4 and 14

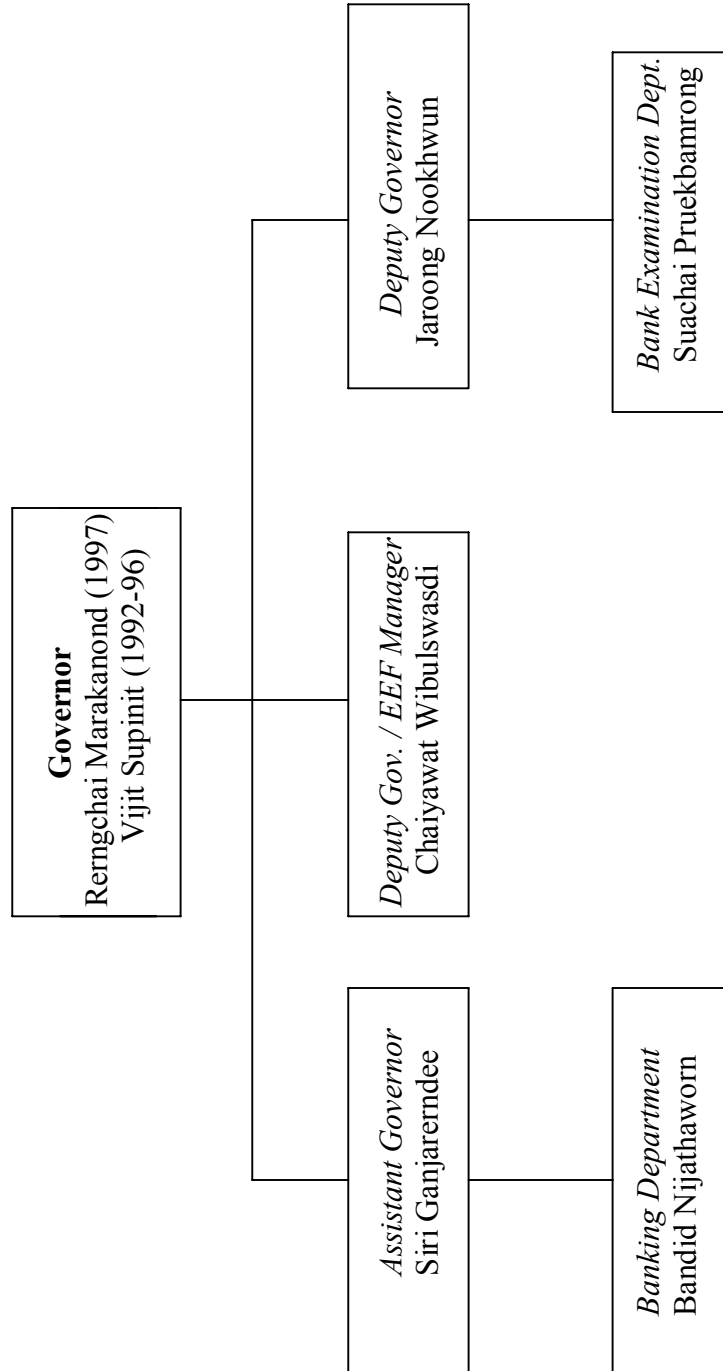


Figure 4.6: Internal Organization of the Bank of Thailand, July 2nd 1997 (source: Bank of Thailand)

revealed that the Bank of Thailand staff had underestimated the true risk exposure of the finance company sector prior to the crisis.¹⁰⁰

The Bank of Thailand's overriding commitment to defend the exchange rate forced the Bank of Thailand to adopt a policy of unlimited generosity towards failing financial institutions. The most notorious of the Bank of Thailand's policy of unlimited forbearance was the case of the Bangkok Bank of Commerce. In 1992, central bank officials first became aware of the BBC's condition. In accordance with the powers granted the Bank of Thailand by the 1962 Commercial Banking Act, the central bank ordered BBC management to increase capital by Bt 800 million and further required the BBC to formulate a rehabilitation plan. By March 1993, however, a Bank of Thailand examination revealed that the BBC's NPLs had risen to Bt 38.5 billion or 39.6 percent of total assets, indicating that BBC's management continued to grant questionable loans without hesitation. The central bank once again ordered BBC's CEO, Krik-kiat Jalichandra, to increase BBC's capital by Bt 3 billion. Although the Bank of Thailand hoped that capital injections alone could solve BBC's problems, another examination in 1994 established that BBC's NPLs remained above Bt 20 billion.¹⁰¹

Once it became clear in 1995 that the BBC management was resisting the pain of recapitalization and management reform, the Bank of Thailand faced a moment of decision. Jaroong Nookhwun, Deputy Governor for Banking Affairs, asked the Supervision Department to prepare a report detailing BBC's problems. However, Jaroong apparently found that the evidence of fraud was so extensive that he kept the results confidential, out of fear of the consequences that would ensue if the truth were ever revealed to the public. During post-crisis testimony, Jaroong claimed that the report was never submitted to the Central Bank Governor Vijit, and Jaroong also

¹⁰⁰ Interview by the author, Bangkok, August 2000

¹⁰¹ *The Nukul Commission Report*, 127

testified that he had decided to deal with the BBC privately.¹⁰² Yet it is difficult to conceive that Governor Vijit, who was a friend of the directors of the BBC, had no knowledge of the corruption infesting the bank. Even if Vijit was not formally informed, as central bank governor, it was Vijit's responsibility to know that the 9th largest bank in the country was so deeply riddled with fraud. The Bank of Thailand should have ordered a replacement of the BBC's management or temporarily nationalized the bank, but instead the central bank gambled upon resurrection, in the hope that the BBC could be rehabilitated without public disclosure of the extent of the bank's troubles.

The Bank of Thailand's neglect of bank-level governance reforms prior to financial opening had three distinct consequences. First, the Bank of Thailand underestimated the degree to which Thai financial institutions were exposed to risk, explaining why the central bank believed that the troubles of the Bangkok Bank of Commerce were unique. Second, the lack managerial accountability meant that bail-outs could actually retard instead of facilitate the rehabilitation of troubled financial institutions. Third, insufficient information regarding the true risk exposure of domestic financial institutions caused the central bank to defend the fixed exchange rate regime for far too long in the hope that financial sector problems could be resolved.

¹⁰² Interview by author, Bangkok Thailand, July 2000

3.33 Credibility at all Costs: The Political Economy of the Baht Defense

The most intense political pressure to maintain the fixed exchange rate came in the form of the parliamentary elections of 1995, which brought the Chat Thai party and Banharn Silpa-archa to power. Banharn's power base came from his ability to funnel central government resources to his supporters in the rural provinces, and his reputation as a consummate political insider was such that he had been investigated for being "unusually rich" during the Chatichai era of the late 1980s. The price of Banharn's election success was \$400 million, part of which his supporters were caught distributing to rural voters, and which thereby gained Banharn the dubious accolade of "the walking ATM machine."¹⁰³ Similarly, Banharn maintained the coherence of his widely based government by assuring the coalition members who represented the Bangkok business elite and the rural provinces that cheap international capital would continue flowing, which in turn, depended upon the maintenance of the fixed exchange rate regime.

As finance minister, Banharn chose Surakiart Sathirathai, but had to replace him in early 1996 because of the public uproar that ensued after Surakiart fired the popular SEC chairman, Ekamol Khiriwat.¹⁰⁴ Ekamol was threatening legal action against the BBC, a move that angered Banharn's coalition partners, and so at the behest of the minister of finance, the central bank governor dismissed Ekamol. The public outrage that followed Ekamol's summary dismissal forced Banharn to replace the finance minister, but Banharn still had to accommodate his business allies, and so

¹⁰³ Banharn's supporters were caught distributing 11 million baht. It has been estimated that the price of each vote in the rural districts was \$60 per vote. In response to allegations of corruption, the Chat Thai spokesmen dismissed vote-buying as "normal business practice." Phongpaichit and Baker, *Thailand's Boom and Bust*, 259

¹⁰⁴ Danny Unger, *Building Social Capital in Thailand*, (Cambridge University Press, 1998), 100; Lauridsen, *Tigers in Trouble*, 146. Surakiart had actually recommended that BoT Governor Supinit should fire Ekamol, but the termination of Ekamol was considered to be the work of the Finance Minister.

the Prime Minister then selected Bodi Chunnananda to head the finance ministry. Bodi's chief distinction was that as a budget bureau official, he had reportedly helped to channel large portions of the government's budget to members of Banharn's constituency. Because of the Ekamol affair and due to the reputation of many of Banharn's cabinet ministers, the media dubbed the new regime "the 7-Eleven government – composed of seven parties and eleven factions and, like a convenience store, was open for business twenty-four hours."¹⁰⁵

Unfortunately for the Thai economy, it was precisely during Banharn's tenure as prime minister that bad news regarding the health of Thailand's financial sector began to surface. The first sign of vulnerability emerged when the rate of Thai export growth decelerated from the stratospheric average of 21 percent of the previous decade to a much more modest 7 percent in the first quarter of 1996. The negative trend continued, and at the end of 1996, export growth was at zero. In a sense, the deterioration of the Thai external balance and the over-valuation of the exchange rate were over-determined. Increasing real wages, a weakening of the yen against the dollar, a slump in Japanese demand for imports, and a retraction of Japanese investment from the entire region, all contributed to Thailand's slowing growth rate. Furthermore, Thailand was under increasing pressure from regional competitors in electronics and manufactures.¹⁰⁶ To continue expanding, Thai firms began accumulating an alarming external debt profile. Although the export slump had been long anticipated by many Thai economists, the combined effect of external imbalance and capital inflows upon the Thai financial sector had detrimental consequences far beyond anyone's expectations.

¹⁰⁵ Phongpaichit and Baker, *Thailand's Boom and Bust*, 260

¹⁰⁶ Phongpaichit and Baker, *Thailand's Boom and Bust*, 116-117

In May 1996, the seemingly unlimited patience of the Bank of Thailand with the BBC became international news when Democrat MPs used the BBC affair to mount a no-confidence debate against the Banharn government. During the debate, it was revealed that Newin Chidchob, the deputy minister for finance, Suchart Tancharoen, a deputy interior minister and two other Chat Thai MPs, had taken large loans from the BBC and used the loans to purchase land that was then used as collateral for leveraged takeovers and share speculation.¹⁰⁷ Further damage was sustained to Banharn's coalition when the government acknowledged that half of the project finance budget had been lost to corruption.¹⁰⁸ As if this was not enough, Central Bank Governor Vijit and Finance Minister Surakiat were forced to resign in July 1996 under a cloud of suspicion and recrimination for their part in the BBC scandal, fueling speculation about the health of the financial sector. Banharn responded by reshuffling his cabinet and promising an anti-corruption campaign, which led his opponents to demand another no-confidence debate. The debate turned into a three-day impeachment trial of the prime minister that ascended to high political theatre, and led ultimately to a new round of elections late 1996.¹⁰⁹

In late November 1996, financial markets responded to the news of widespread corruption in the Banharn government by initiating speculative attacks against the baht for the first time since the Mexican peso crisis. Moreover, the results of the 1996 elections did little to reassure the nervous markets, as the New Aspiration Party came to power under the leadership of Chavalit Youngchaiyudh. Chavalit was an ex-general who had served as defense minister under Banharn and he had successfully extended the New Aspiration party's electoral base by reaching out to the Bangkok business elite and the rural provinces. Chavalit's political success allegedly cost the

¹⁰⁷ Phongpaichit and Baker, *Thailand's Boom and Bust*, 259

¹⁰⁸ As one observer noted: "The budget is like a popsicle that's passed around. Everyone gets a lick at it." quoted from Phongpaichit and Baker, *Thailand's Boom and Bust*, 260

¹⁰⁹ Phongpaichit and Baker, *Thailand's Boom and Bust*, 263

New Aspiration Party approximately \$500 million in vote-buying and coalition building.¹¹⁰ Thus, another potentially unstable coalition government took power at precisely the moment when the Thai economy required decisive action. Any hope of responsible economic policy faded when Chavalit, the self styled “reformer” and “son of the rural northeast” (*luk isan*), formed a cabinet that contained six ministers who had been investigated in 1991, along with Banharn, for being wealthy beyond their means.¹¹¹

Almost immediately following the formation of Chavalit’s cabinet, speculators began attacking the baht, increasing international concerns regarding the future of the fixed exchange rate system. In order to address the emerging weakness in the financial sector, Chavalit appointed Dr. Amnuay Viravan, who had a reputation for fiscal rigor, to lead the finance ministry. Instead of selecting a highly respected technocrat to head the central bank, Chavalit selected Rerngchai Marakanond, a trade lawyer who had little experience with banking supervision or financial sector reform, to be Governor of the Bank of Thailand. Rerngchai, who served as Governor from July 1996 to July 1997, was obsessed with protecting the fixed exchange rate system and continued Vijit’s approach of throwing taxpayer money at any financial institution that had liquidity or solvency problems. After the BBC bailout proved ineffective, in August 1996, the FDIF began assisting six finance companies including Thai Fuji Finance, which was associated with the BBC.¹¹²

When the property bubble burst in the first quarter of 1997, the Ministry of Finance and the Bank of Thailand finally took decisive action in an attempt to head off any further bankruptcies. In early March, the government announced the establishment of the Property Loan Management Organization (PLMO) which was to

¹¹⁰ Lauridsen, *Tigers in Trouble*, 147; Estimates of the total spent upon vote-buying during the November 1996 parliamentary elections for all Thai political parties range between \$700 million - \$1 billion.

¹¹¹ Phongpaichit and Baker, *Thailand’s Boom and Bust*, 266

¹¹² *The Nukul Commission Report*, 143

provide 100 billion baht in five year loans to finance companies overextended in the property market. But the cornerstone of the authorities' financial rehabilitation plan was the announced merger between Finance One, Thailand's largest finance company and Thai Danu Bank, the twelfth largest commercial bank. In order to assure the success of the merger, the FDIF injected Bt 40 billion into Finance One's balance sheet. Had the Thai Danu-Finance One merger succeeded, the government would have proceeded with further mergers between Thailand's 91 finance companies and 18 banks. But the merger failed in May 1997 and consequently, the government's financial rehabilitation strategy unraveled.¹¹³

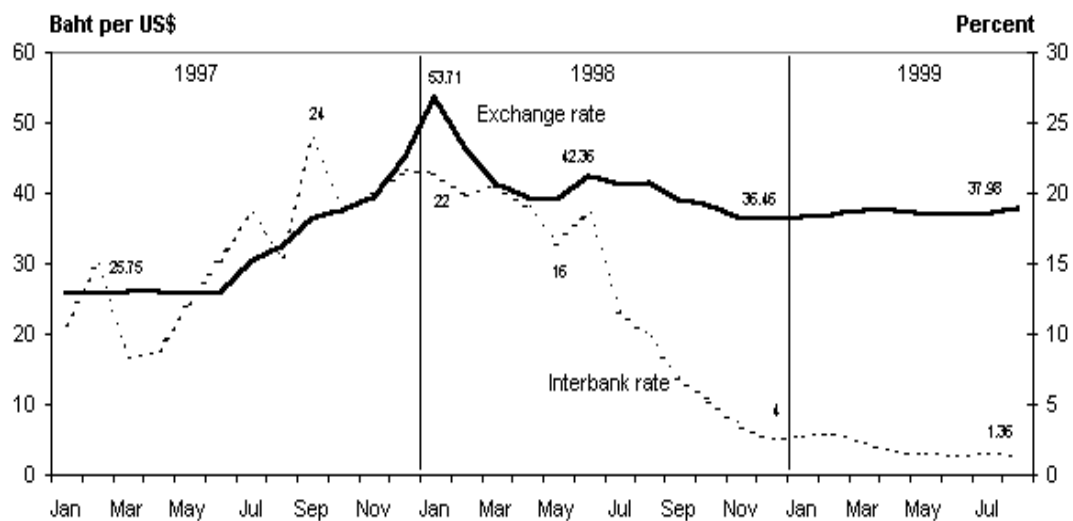


Figure 4.7: The Failed Defense of the Thai Baht, 1997-98

Once the government's merger plans imploded, the unforgiving markets once again set upon the Bank of Thailand. As illustrated in Figure 4.7, between May 13 and May 15, speculative pressures culminated in the most severe and sustained attack

¹¹³ Laurisden, *Tigers in Trouble*, 148

upon the baht since the fixed exchange regime was introduced in 1984.¹¹⁴ The speculative attacks against the Thai baht in mid-May caused a panic within the Thai banking community and it was at that point that the Bank of Thailand became desperate. In a series of meetings between May 13 and May 14, the assistant governors met with Governor Rerngchai, and it was agreed that the Banking Department would engage in a set of interventions beginning with \$300 million, to nudge the baht spot rate back into the announced EEF band. A second intervention on the morning of May 14 was coordinated with the Hong Kong Monetary Authority, which contributed \$500 million in support of the baht. By the end of the day on May 14, the Bank of Thailand had expended a total of \$ 9.7 billion to defend the baht, which included \$ 5.4 billion committed to swap transactions.¹¹⁵ Yet despite the scope of the interventions the speculators refused to back off.

And so came about the fateful decision on the evening of May 14th, by top central bank officials, to grant the Banking Department authority to engage in swap transactions “with no limit on the amount of money used.”¹¹⁶ Consequently, during the evening of May 14th and throughout the morning of May 15th, the Banking Department expended \$10 billion in the New York and London currency markets in an effort that finally brought the baht back within the announced Bt 25.85 – Bt 25.90 range.¹¹⁷ But alas the fight to defend the baht had nearly exhausted the Bank of Thailand; as the central bank’s available reserves had fallen from the robust position of \$24.3 billion that were held at the beginning of May, to an anemic \$2.5 billion by the morning of May 15th. Acting quickly, and in an effort to deny currency speculators ammunition for further attacks, the Bank of Thailand forbid lending of the Thai baht to foreign financial institutions. The measure worked to a degree,

¹¹⁴ *The Nukul Commission Report*, 76-80

¹¹⁵ *The Nukul Commission Report*, 80

¹¹⁶ *Memo 379/1997* from Banking Department Director Bandid to Assistant Governor Siri on May 22, 1997

¹¹⁷ *Memo 379/1997*

increasing net foreign exchange reserves to \$7.3 billion by May 16, a position that was maintained until mid-June.¹¹⁸

Unfortunately the bad news was not over. Ominously, in late May, three senior central bank officials were suspended for their alleged incompetence at handling the BBC affair, and on June 19th, Finance Minister Amnuay resigned as deputy prime minister and minister of finance, reportedly because Chavalit would not grant him sufficient power to balance the budget and discipline mismanaged finance companies.¹¹⁹ Financial markets, in turn, interpreted Amnuay's resignation and the suspension of central bank officials as evidence that the Chavalit government was no different than Banharn's 7-Eleven government. Increasingly, it became apparent that the Chavalit government was too well connected with the business community to challenge the very political interests that financed New Aspiration's rise to power.

After Amnuay's resignation, Chavalit appointed Thanong Bidaya as minister of finance, but by then there was little that Thanong or the Bank of Thailand could do to defend the baht from speculative attacks. The final stroke against the fixed exchange rate came on June 27 when 16 finance companies were suspended for 30 days. In a last desperate attempt to save the baht peg, on July 1st, Prime Minister Chavalit declared: "I will never allow the baht to devalue. We will all become poor." One day later, on July 2nd 1997, after conferring with the Prime Minister, the Bank of Thailand announced the introduction of a "managed float", and in response the baht fell from 26 baht to the dollar to 32 baht to the dollar in less than two weeks.¹²⁰

The immediate reason for the baht's collapse was the Banking Department's mismanagement of the central bank's foreign exchange reserves. The deeper reasons lay in the fact that the central bank's leadership, and Deputy Governor Chaipayat

¹¹⁸ *The Nukul Commission Report*, 81

¹¹⁹ Laurisden, *Tigers in Trouble*, 147

¹²⁰ Laurisden, *Tigers in Trouble*, 148

Wilbulswadi in particular, was unwilling to introduce flexibility into the management of the exchange rate system when economic and political conditions were more amenable. And yet the rest of the Bank of Thailand staff was hardly blameless, as neither Governor Vijit nor Governor Rerngchai was willing to take effective action to punish the BBC and other corrupt financial institution. Nor did the central bank extend support to panicking depositors; a measure that may have been costly in the short term, but would have ultimately calmed the markets in the long run. Finally, the collapse of the baht peg was inevitable, because increasingly since 1992, whoever held the prime minister's office was more concerned with maintaining the elected coalition's access to easy credit than with preserving the stability of the Thai economy.

4.34 Bailing out the Wealthy: The Social Distribution of Bankruptcy Costs

The social distribution of bankruptcy costs can be measured in two ways. First, during the pre-crisis bailout, billions of baht in public funds were poured into illiquid and insolvent financial institutions without requiring that major shareholders to pay for the cost of their actions. The Bank of Thailand's permissive attitude during the failed attempt to rehabilitate the BBC was extended to the central bank's response to the insolvent finance companies. Prior to the floatation of the baht, public money was offered to the troubled finance companies without imposing discipline upon the management or major shareholders. And in the case of Finance One Plc., which was formerly Thailand's largest finance company, the firm's managing directors allegedly embezzled the central bank's largesse.

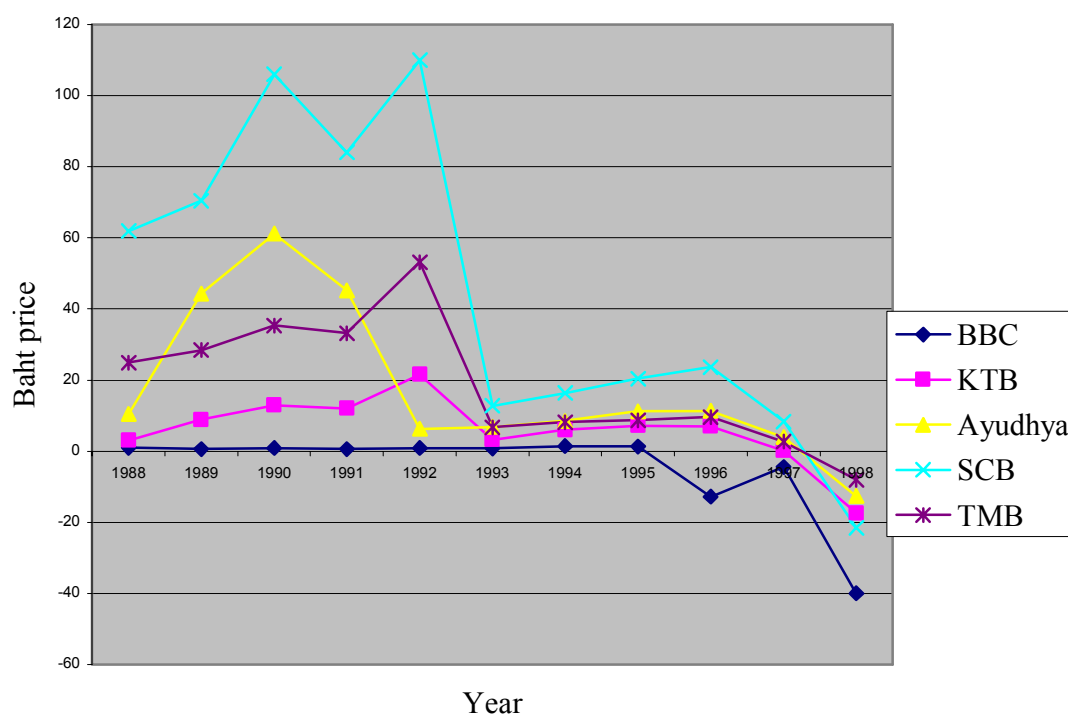


Figure 4.8: Banking Sector Earnings per share
(Source: Krung Thai Research Department)

The cost of insolvency was thus completely borne by minority shareholders and by the public treasury. The second way of gauging how the costs of bankruptcy were distributed is by identifying the effects of the crisis upon the different segments of Thai society. Through the FIDF and other means, Thai taxpayers were forced to pay for the bulk of the bankruptcy and rehabilitation costs. The least fortunate members of Thai society also had to pay for the crisis in the form of a decline in real income and the contraction of employment opportunities.

Figure 4.8 illustrates the loss to shareholders from the period of economic expansion and Figure 4.9 represents profits and losses in the banking sector. While bank manager's made a fortune extending relationship loans during the early 1990s, the bank's minority shareholders were forced to endure a devaluation of their shares. From the BBC bailout of 1996 to the floatation of the baht in July 2nd 1997, the FDIF

poured Bt 510 billion (\$10 billion) into the rescue of troubled financial sector, with Bt 90 billion of this sum going to the failed attempt to rescue the BBC.

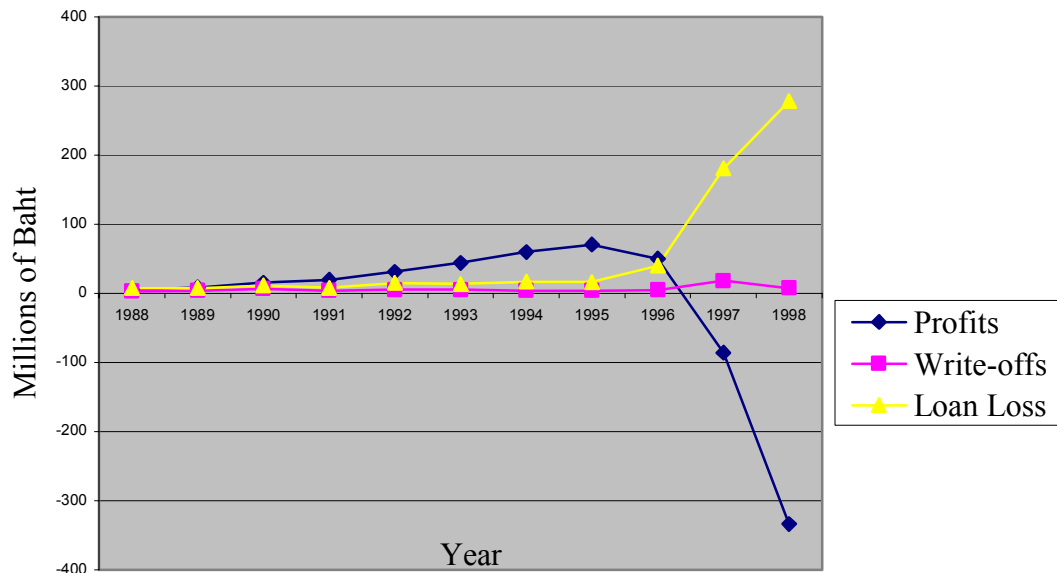


Figure 4.9: Profits/Losses of Thai Banking Sector
(Source: KTB Research Department)

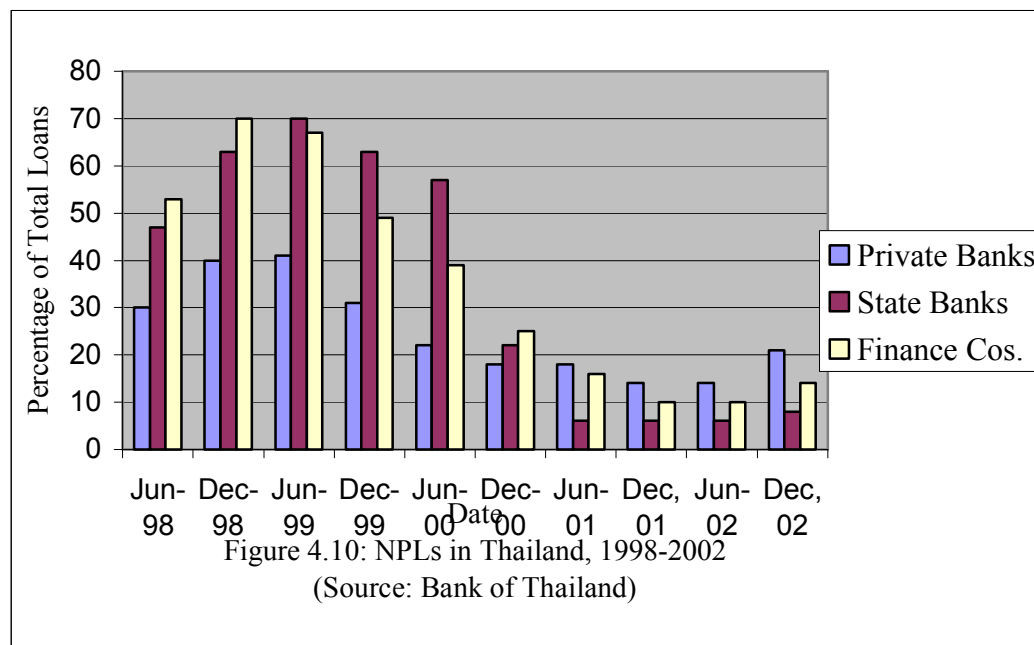
In December 1997, the publicly disclosed level of NPLs equaled Bt 1.02 trillion, or 20.7 percent of total loans, which was an increase of 171.4 percent from June 1997.¹²¹ As illustrated in Figure 4.10 below, the level of NPLs became even greater when the new classification system was instituted in 1998.¹²² Using the new standard, NPLs reached a level of 45 percent in December 1998 and peaked at 47.7 percent in May 1999.¹²³ And as of September 2002, unresolved NPLs were still at Bt 1.04 trillion which represented 21.9 percent of total lending, with nearly half of the

¹²¹ In June 1997, the total reported percentage of NPLs was 8.52 percent, or a baht value of Bt 375 million. See: Tisco Thailand Research Department. *Thailand Banking Sector: The Dawn of a New Era* (Bangkok: May, 1998).

¹²² Parista Yuthamanop, "New formula lifts debt total by about \$20 bn," *Bangkok Post*, 1 July 2000.

¹²³ *Thailand: From Crisis to Sustainable Recovery*, Ministry of Finance (Bangkok: May, 2000), 16.

unresolved NPLs still held by banks (Bt 300 billion) and finance companies (Bt 169.2 billion).¹²⁴



The first and most significant bailout was the failed attempt to rescue the Bangkok Bank of Commerce. By 1995, the central bank had concluded that without an injection of capital into BBC's balance sheet, the troubled bank would fail. Fearing the effects of the BBC's collapse upon the rest of the financial sector, Vijit Supinit, who was also known to be a personal friend of BBC's CEO Krirk-kiat Jalichandra, decided to marshal the resources of the Fund for Development of Financial Institutions (FIDF) and the Government Savings Bank (GSB) in order to bail out BBC.¹²⁵ Krirk and his chief financial advisor, Rajesh Saxena, decided to take advantage of the government bailout scheme, and instead of using the funds to repair

¹²⁴ Anoma Srisukkasem, "Unresolved NPLs: Bad loans still plague the system," *The Nation*, 14 September 2002.

¹²⁵ *The Nukul Commission Report*, 129

the bank's balance sheet, the BBC managers allegedly expanded the scope of their illegal activities.

BBC's management proceeded to manipulate the bank's share price and thereby increase BBC's paid-up capital. Saxena hired Sia Song, a shadowy figure from Thailand's financial underground who was famous for being charged, and later acquitted, of securities fraud in 1984. Song's participation in BBC's management further attracted the attention of the "Group 16", a set of Thai parliamentarians who were intent upon using BBC for their own financial gain.¹²⁶ In sum, BBC had become the politician's bank *par excellence* and yet the Bank of Thailand failed to take prompt and corrective action against the bank's management.

The bailout of the BBC was also significant because the BBC rescue plan set the tone for the remainder of the FIDF intervention. The first flaw of the FIDF assistance plan was that the BBC did not have to commit to a capital write-down, which would have imposed an outside assessment of the value of its assets and would have compelled the BBC's primary shareholders to absorb the cost of the failed assets.¹²⁷ In failing to order a write-down, Vijit and Jaroong allowed BBC's management to benefit from the new injection of capital without having to bear any personal liability for losses and thus forced the new shareholders (the public, since it was a government bailout) to shoulder the entire cost of the (failed) rehabilitation process. The second defect of the FIDF pre-crisis bailout was that the central bank made no attempt to replace Krik-kiat or any of the BBC management. Only Rajesh Saxena was ordered to relinquish his position at BBC and was forced to suspend any dealings with the bank.¹²⁸ By allowing Krik-kiat and BBC's board of directors to retain management control, Central Bank Governor Vijit hoped to enlist the

¹²⁶ Phongpaichit and Baker, *Thailand's Boom and Bust*, 107

¹²⁷ *The Nukul Commission Report*, 131

¹²⁸ *The Nukul Commission Report*, 133

management's aid in loan recovery, but instead the Bank of Thailand reinforced the message that the BBC shareholders would be free from personal liability.

The same bailout pattern continued with the attempt to rehabilitate the non-bank financial sector. Following the bursting of the property bubble in early 1997, many real estate and finance companies became insolvent. Somprasong Land Company and a number of other real estate firms defaulted upon their Euro-bond interest payments in February 1997. When insolvency spread to Finance One, the Bank of Thailand and Ministry of Finance announced a forced merger between the finance company and Thai Danu Bank, the 12th largest pre-crisis commercial bank. But the Finance One merger failed in part because there was no public interest in the merger and because it was revealed that many Chat Pattana and New Aspiration ministers were among the failed finance companies main shareholders. Undaunted, the FIDF injected Bt 40 billion into Finance One's balance sheet to prepare the finance company for the merger and nine other finance companies were ordered to raise Bt 26 billion in total as a cover for future repayments to international creditors. By July 1997, the Bank of Thailand had extended \$8 billion (Bt 430 billion baht) more in public funds in order to bail out the ailing finance companies.¹²⁹

Because of the \$18 billion in total pre-crisis bailouts and as a result of the government role in absorbing bankruptcy costs, the public debt increased four-fold within the four years following the crisis. The public debt ballooned from Bt 690 billion in 1996 to Bt 2.9 trillion in September 2001, but then settled to Bt 2.6 trillion in April 2002, which was equivalent to 51.9 percent of Thai GDP.¹³⁰ And if the total losses incurred by the FIDF are included in the tally, then the public debt would rise to 75 percent of the 2002 GDP.¹³¹ Under the guidance of the International Monetary

¹²⁹ Laursiden, *Tigers in Trouble*, pg. 149

¹³⁰ *Thailand: From Crisis to Sustainable Recovery*, Ministry of Finance (Bangkok: May, 2000), 16.

¹³¹ Public Debt Management Office (PDMO) of the Ministry of Finance, and personal communication, Ammar Siamwalla, December 2002

Fund, the FIDF nationalized six banks and twelve finance companies, in addition to the closure of the 56 defunct financial companies. In total, the government was forced to absorb approximately Bt 300 billion (\$72 billion) of private sector debt (from mostly short term international obligations) and according to TDRI estimates, the government will eventually be forced to bear another Bt 110 billion (\$29 billion) from the unrecoverable assets of the 56 closed financial firms.¹³²

The outbreak of the crisis in late 1997 undermined the Chavilit government and brought about another round of elections. In January 1998, voters returned the Democrats to power and so it was Chuan Leekpai, the defender of the Bangkok business elite, who administered the post-crisis distribution of bankruptcy costs. The new government responded to the crisis by absorbing much of the bad loans generated by the failed banks and finance companies. By contrast, government activism aimed at mitigating the effects of the crisis on the poorer sectors of Thai society yielded only mixed results. According to the Ministry of Finance, financial support from the World Bank (\$300 million) and the Japanese Overseas Economic Cooperation Fund (¥13.4 billion) was used to benefit 200,000 trainees and workers in 1999 and 127,312 trainees and workers in 2000. Another \$500 million from the Asian Development Bank has also been disbursed in the form of unemployment, social welfare, and educational support.¹³³

Although the Chuan government made great efforts to advertise social assistance programs, Thai unemployment levels increased from 2 percent in 1997 to 5 percent in 1998, which translated to an increase from 0.6 million to 1.5 million unemployed workers. By 1999, the number of unemployed reached over 2 million but decreased to 1.5 million in 2000.¹³⁴ A sectoral analysis reveals that in late 1998,

¹³² PDMO and personal communication, January, 2003

¹³³ Ministry of Finance, *Thailand: From Crisis to Sustainable Recovery*

¹³⁴ Nancy Birdsall, The Social Fallout: Safety Nets and Recrafting the Social Contract, In: Stephen Haggard, ed *The Political Economy of the Asian Financial Crisis* (Washington, D.C.: Institute for International Economics 2000), 195.

one year following the crisis, the sector that was most effected by the crisis, the construction and real estate sector, also suffered the greatest contraction in employment levels (-32 percent), while the commercial and manufacturing sectors endured far less severe employment contractions (-3 and -2.4 percent respectively).¹³⁵

A regional breakdown of unemployment levels is also instructive, in that the poorest region, the rural North East, accounted for 40 percent of total unemployment levels in 1998. For instance, in 1998-1999, in the rural village of Sap poo pan in the Tambon province, 40 villagers out of a total village population of 260 were forced to return from urban area jobs because of the effects of the crisis. In Chang Mai province as a whole, unemployment levels increased from 2,117 unemployed workers in 1996 to a staggering 55,586 in 1998 (an increase of 910 percent).¹³⁶ Overall however, it seems that the rural households fared somewhat better than the national average.

The effect of the crisis upon real wages was significant. Among the poor urban neighborhoods real wages declined at least 14 percent, while the real wages of the rural poor declined by 18 percent. Between 1996 and 1998, the percentage of families living below the \$2 per day poverty line increased from 14.9 to 16.9 in most rural areas. As in the case with unemployment levels, the rural Northeast suffered the most, as the percentage of the poor increased from 19.3 to 22.7 percent. The number of urban area poor increased more modestly from 3.8 to 4.4 percent for the same period.¹³⁷

The per capita cost of the crisis also supports the view that the government treated bank managers kindly. For instance, between 1997 and 2002, each taxpayer in Thailand paid Bt 18,000 for the government bailout, while the shareholders of the

¹³⁵ Birdsall, *The Political Economy of the Asian Financial Crisis*, 195

¹³⁶ *Northern Thailand Unemployment*, National Trade Databank (Washington, D.C.: U.S. Department of State and U.S. Department of Commerce, 2000)

¹³⁷ Birdsall, *The Political Economy of the Asian Financial Crisis*, 195

failed firms have paid only Bt 10,000. Furthermore, assuming that 65 percent of the NPLs still held by the FIDF will never be recovered the World Bank estimates that the public treasury will lose an extra Bt 1.38 trillion, which would mean that the per capita cost of the bailout for each taxpayer in Thailand would be Bt 37,000. The costs of debt restructuring do not end there however, since a further Bt 886 billion remains outstanding as of 2003, which would add another Bt 9,000 to the cost borne by each taxpayer.¹³⁸

Bankruptcy costs were distributed according to the political power of the finance industry, although the government insisted that Thai firms pay for at least some of the costs of the crisis. Government intervention put a great deal of stress upon the alliance between Thai bankers and Thai politicians, but since every coalition government is backed by the business community, the financial industry could easily reassert its influence during the bailout process. Although the Thai financial sector received billions of baht in public funds, Thai banks and corporations were loath to face their creditors. Bankruptcy in Thailand is a rare event and was never before executed on a scale required by the post-crisis settlement. Thus, despite government pressures, Thai firms resisted the bankruptcy process at every turn, causing the post-crisis cleanup process to be just as contested as the bailout procedure.

4.35 The Banker's War: Resisting Bankruptcy Settlement

Thailand's default upon \$190 billion in foreign debt at the end of 1997 forced the Chuan government to confront Thailand's banking and corporate sectors directly. The first task facing the government was to design a settlement procedure that could distribute the costs of bankruptcy appropriately. Because of there importance, the

¹³⁸ Jiwal Kanoksilp, "Non-performing Loans", *The Nation*, June 4, 2002

new bankruptcy laws became a source of political conflict, as major shareholders and their political allies resisted the establishment of the New Central Bankruptcy Court. Chuan responded to the understandable reluctance of banking and corporate sectors by establishing the Financial Restructuring Agency (FRA) in July 1998 and the Corporate Debt Restructuring Advisory Committee (CDRAC) in 1998.¹³⁹ But when many of the largest corporate debtors balked at the terms of the proposed settlement process, the battle for the distribution of bankruptcy costs began in earnest.

The FRA was intended to evaluate the rehabilitation plans of the 58 suspended financial companies in order to determine which of the companies were irredeemably insolvent and would have to be closed. Accordingly, in December 1997 the FRA recommended that 56 of the 58 suspended should be permanently closed, and in June 1998, another 5 companies were to be closed. With regards to the remaining 15 banks and 33 finance companies that continued operating, the FIDF was charged with task of offering these institutions a very limited access to liquidity reserves while simultaneously tightening the loan classification system, strengthening capital provisioning rules and increasing capital adequacy requirements to more accurately reflect credit and market risk.¹⁴⁰

Chuan's strategy was to compel the large shareholders of the viable banks to bare the burden of recapitalization. But due to the inability of less solvent banks to solicit new equity injections, taxpayers were forced to shoulder the remainder of Thailand's bad debt. In response to the new requirements, Thai Farmers Bank and Bangkok Bank succeeded in raising new equity capital, while Thai Danu Bank, Thai Farmers Bank, and the Bank of Asia found foreign partners to shore up their balance sheets and rebuild their management models. However, Siam City Bank, First

¹³⁹ Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, D.C.: Institute for International Economics, 2000), 156-57

¹⁴⁰ Haggard, *The Political Economy of the Asian Financial Crisis*, 156-57

Bangkok City Bank, Bangkok Metropolitan Bank and of course the Bangkok Bank of Commerce, were unsalvageable and were essentially nationalized under the administration of the FIDF.¹⁴¹

In order to prepare the unsalvageable banks for future sale, taxpayers were forced to pay for the equity injections, re-capitalization programs and further liquidity support. As a result, the cost of the public rehabilitation plan rose to 20 percent of the GDP by the end of 1998. The Chuan government attempted to recoup some of the losses of the public treasury through a series of 11 auctions that ended in April 1999, in which 25 percent of the assets in the FRA's possession were sold for the relatively meager price of \$4 billion.¹⁴² And even then, the main purchaser of the troubled assets was the Thailand Asset Management Corporation (TAMC). Viable assets were then transferred to Ratanasin Bank, which was to serve as a government sponsored "good bank." These efforts, which were reasonably successful given the circumstances, left the taxpayers holding the bill for the FRA's auctions.¹⁴³

The most divisive and politically charged issue for Chuan's government was corporate debt restructuring, which had obvious implications for how the crisis-generated debt would be distributed between taxpayers and shareholders. To facilitate debt restructuring, the Chuan government established the CDRAC. The CDRAC framework allowed banks and corporations to keep bad loans off of their balance sheets as long as these institutions were willing to engage in debt restructuring. But because foreclosure laws that clearly delineated responsibility between debtors and creditors had yet to be passed by the Thai parliament, banks and

¹⁴¹ Haggard, *The Political Economy of the Asian Financial Crisis*, 157

¹⁴² Santiprabhob, Veerathai, "The Thai Framework for Financial Sector Restructuring: How has it Supported Recovery?" *Working Paper 2000/3*, Policy Research Institute, Fiscal Policy Office, (Bangkok: Ministry of Finance 2000), ; Haggard, *The Political Economy of the Asian Financial Crisis*, 157

¹⁴³ Nophakhun Limsamarnphun, "Watchdog: TAMC: Real Savior of the Thai Economy," *The Nation*, 9 December 2001. The TAMC absorbed Bt716.82 billion of the failed financial institution's bad loans. After debt restructuring, the agency has remaining NPLs of Bt598.46 billion as of June, of which Bt516.11 billion is still unresolved.

firms refused to engage in meaningful debt restructuring. The government was then forced to grant an amnesty to uncooperative institutions. To convince firms and banks to behave more agreeably, the Chuan government devised another plan in August 1998 that reduced the recapitalization requirement for distressed banks. The new rules also increased the severity of the consequences for any banks that refused to abide by the recapitalization policy, including the threat of removal, by government decree, any uncooperative bank managers.

Banks responded by using short term financing as a means of circumventing government recapitalization guidelines. Such methods were costly, but allowed banks to retain full control of the debt restructuring process. Simultaneously, the political allies of banks and firms in parliament went on the offensive, focusing their attention upon the new bankruptcy and foreclosure legislation, which intended to make it much easier for creditors to gain access to the assets held by unresponsive debtors. Not surprisingly, the strongest resistance to the new legislation came from senators who were major shareholders in Thai Petrochemical and NTS Steel.

Although the lower house of the Thai parliament could have over-rode the objections of the Senate, the parliamentary review process attracted sufficient public attention as to give the senator-businessmen sufficient leverage to wring concessions out of the more ambitious of House committee members. Primarily due to Senate resistance, the Chuan government required 15 months to pass the new bankruptcy and foreclosure legislation.¹⁴⁴ The concessions forced by the business-dominated senate yielded a bankruptcy appeal process had successfully undermined the original intention of the bill. As a consequence, by the end of 1999, the financial sector had filed only 37 bankruptcy petitions with the central bankruptcy court and in fact, the

¹⁴⁴ Haggard, *The Political Economy of the Asian Financial Crisis*, 160

most successful debt restructuring occurred privately and through the CDRAC framework.¹⁴⁵

4.36 Escape from Bangkok: Managerial Accountability and Law Enforcement

The post-crisis reform process could never be judged successful without a method to compel bank and finance company managers to accept responsibility for the corporate governance failures that preceded the crisis. Legal and institutional reforms spearheaded by the Bank of Thailand focused upon prosecuting cases against former managers of the bankrupt financial institutions. Other measures adopted by the SEC targeted corporate governance reform, while the Prime Minister's Office committed the government to reforming the bankruptcy laws, which included the contentious issue of the establishment of the central bankruptcy court in 1999. The results so far have been mixed and while the new bankruptcy court has recently ruled against several of the largest delinquent debtors, the lack of progress against alleged embezzlers indicates how far Thailand has yet to go in order to recover fully from the 1997 crisis.

The first level of institutional reforms that followed the crisis focused upon the Bank of Thailand. As part of a modernization of the central bank's organizational structure, the reform effort focused upon the departments that had been most responsible for aggravating the financial sector's vulnerability; the Monetary Policy Department, the EEF, the Financial Supervision Departments, and the Legal Department. The bank's overall structure has been flattened; ostensibly to help information flow from the lowest layer of the central bank's bureaucracy to the Governor's office. The Court of Supervisors and External Auditing Office have been

¹⁴⁵ Haggard, *The Political Economy of the Asian Financial Crisis*, 158-161

strengthened and given greater powers of oversight. Monetary policy at the Bank of Thailand has been refocused upon a managed float of the Thai baht and the Monetary Policy Board has adopted a policy of inflation targeting. Legal restrictions have also been removed upon EEF operations so that the entirety of the central bank's foreign exchange reserves can now be used, if necessary, to defend the exchange rate. The departments responsible for financial supervision have been given a new system of loan classification that expands the types of questionable loans that supervisors should recognize. Surprise visits by supervisors have also become much more intensive as the central bank struggles to regain its reputation as a tough regulator and supervisor. Finally, the Legal Department has been granted new powers that allow the Bank of Thailand to prosecute alleged violators more effectively.¹⁴⁶

The reform campaign culminated in the establishment of the Office of Anti-Corruption that is presided over by the prime minister. Following the crisis, the SEC was given free rein to be more aggressive with Thai firms and to prosecute cases of misbehavior by governing board members more vigorously. Many of these high profile reform measures were part of the government's marketing strategy to convince the world that Thailand was serious about correcting flaws within the corporate and financial sectors. However, when it came to actually reforming the management models of banks and firms, the government faced a great deal of resistance. And when the government proceeded with the criminal cases that were filed against bank and corporate managers, the results clearly demonstrated the difference between the government marketing strategy and the reality of Thai financial politics.

The first set of problems centered upon prosecuting criminal cases brought by the Bank of Thailand's legal department and by the SEC against the former

¹⁴⁶ Interview by author, Bank of Thailand, Bangkok Thailand, August, 2000

commercial bank executives and the managers of the 56 defunct finance companies. In 1998 and 1999, the Bank of Thailand (under Governor Chatu Mongkol) filed criminal cases against over 100 former executives. The law suits that were filed included 45 criminal liability cases that claimed total damages to depositors and shareholders equal to Bt 42.7 billion.¹⁴⁷ Indictments were filed against Krik-krat Jalichandra, Rajesh Saxena and Sia Song, the notorious managers of the BBC. Indictments also followed against Pin Chakkaphak, the former CEO of Finance One, who was accused of embezzling Bt 2.13 billion and fleeing the country. Even Sirin Nimmanahaeminda, who was the brother of former Finance Minister Tarrin was accused of being involved in financial corruption.¹⁴⁸

Indicting several of the more disreputable characters of the boom era proved to be much easier than bringing many of these cases to court. For instance, the police department and attorney general's office permitted the statutory time limit for the prosecution of several important cases to expire, which enabled accused former executives to escape accountability by fleeing the country. The most notorious of the neglected cases involved Sia Song and eight accomplices, who were charged by the SEC for share price manipulation alleged to have occurred in 1992, in association with Krisda Mahanakorn Plc. The case against Sia Song and his colleagues was significant because the Krisda affair was the largest case of securities fraud in Thai history. The accused men were delivered to the prosecutors in 1996 by the economics crime division and Song was later granted bail pending trial. The pre-trial period gave Song the opportunity to flee to Canada where he still awaits the outcome of an extradition trial. Similarly, the SEC dropped or was unable to enforce 35 out of 61 lawsuits that it had filed over the last ten years against the former managers of

¹⁴⁷ Thanong Khanthong, "Overdrive: Pin case is a blow to the Thai justice system," *The Nation*, 3 August 2001; Anoma Srisukkasem, "Massive Whitewash," *The Nation*, 15 August 2001

¹⁴⁸ Anoma Srisukkasem, "'Culprits' from 1997: Glacial Progress on BoT lawsuits," *The Nation*, 18 August 2001

many prominent financial institutions and corporations, because the police and the attorney general's office allowed the statutory limits upon prosecution of the lawsuits to expire.¹⁴⁹

During the tenure of the Chuan government, the Bank of Thailand led to the successful prosecution of 15 cases of financial fraud, which represented combined financial damages of Bt 9.38 billion. The successful prosecution of the 15 cases was due in large part because shortly following the crisis; Bank of Thailand Governor Chatu recruited Rattakorn Nimwattana to the position of Assistant Governor for Legal Affairs.¹⁵⁰ In the post-crisis environment of anti-corruption, Rattakorn was given the freedom to pursue criminal cases aggressively. Despite early court victories, the period of post-crisis legal activism proved to be politically unsustainable.

The Bank of Thailand's legal efforts came to an abrupt end with the electoral victory of the Thai Rak Thai party (literally: "Thai loves Thai") in January 2001. Thaksin Shinawatra, one of the most successful businessmen in Thailand, led the Thai Rak Thai Party. Thaksin's choice for Bank of Thailand Governor was Pridiyathorn Devakula. In August 2001, Governor Pridi announced that all of the cases against the former executives of the 56 closed financial companies and the cases pending against several former bank managers were being dropped.¹⁵¹ To this date, Pin Chakkaphak, Sia Song, Krik kiat Jalichandra and Rajesh Saxena have managed to successfully avoid prosecution and still await the outcome of their extradition trials in Europe and Canada. And so ended the period of legal activism meant to bring bank managers accused of financial corruption to justice.¹⁵²

¹⁴⁹ Srisukkasem. "'Culprits from 1997'" *The Nation*

¹⁵⁰ Anoma Srisukkasem, "Massive Whitewash," *The Nation*, 18 August 2001

¹⁵¹ Tim Healy and Julian Gearing, "The Game is Up," *Asia Week*, 31 March 2000, Vol. 26, No. 12

¹⁵² Nattha Komolvadhin, "Extradition case: Pin wins appeal," *The Nation*, 28 July 2001

The second set of difficulties for the government arose when the new Central Bankruptcy Court was established in 1999. Political resistance against the establishment of the new court (discussed in section 3.35) was followed by an extended period when some of the largest debtors of the post-crisis era refused to enter into a formal settlement program with their respective creditors. Recently however, on March 13th 2000, the central bankruptcy court ruled against the politically connected Thailand Petrochemical Industries (TPI). TPI's majority shareholder has been a member of parliament from 1998 to 2003, and TPI owed over \$3.5 billion to 140 banks worldwide.¹⁵³ Given the size of the settlement, the government's action against TPI is a reason for optimism regarding future prospects of disciplining debtors who default upon their commitments.

The final set of reforms important for Thailand's financial future are a product of the 1997 constitutional reform process. An underlying structural reason for the Bank of Thailand's inadequate resolve towards the financial sector was the instability of the ruling coalition governments. The 1997 constitutions addressed the stability problem by reorganizing Thailand's multi-member electoral constituencies into single-member electoral districts. The electoral reforms allowed the Thai Rak Thai party to form a majority in the January 2001 parliament; which was only the second time that a single party has succeeded in forming a governing majority. A second set of electoral reforms require parliamentary ministers to register with a political party at least 90 days prior to an election. The registration rule is intended to increase party stability by forbidding defection from one party to another immediately prior to an election. Third, the 1997 election qualification standards stipulate that all candidates must hold at least a bachelor's degree. The educational requirement targets rural

¹⁵³ Steve Miller, "A New Era for Thailand's Bankruptcy Court," *International Practice*, June 2003

notables in an attempt moderate the political influence of the demographically dominant rural electorate.¹⁵⁴

Whether Thailand's bank governance and more extensive political reforms will prove effective is as of yet unknown. Thailand's experience with financial boom and collapse underlines the importance of jealously protecting the authority and reputation of the economic bureaucracy. The Thai story also emphasizes the link between bank governance and regulatory efficacy. Financial liberalization and opening will inevitably prove disastrous for any country unless bank-level governance reforms are first rigorously applied. The choice of an exchange rate regime would then depend, at least in part, upon the type of regulatory system that a country maintains; and under no circumstances should regulatory policy be relaxed in order to support the exchange rate regime. Financial authority also requires a stable relationship between the executive branch of government and the regulatory agency. The Thai case demonstrates that rapid and simultaneous political and financial liberalization render the central bank and other regulatory agencies particularly vulnerable to political manipulation. The problems faced by Thailand are not restricted to multiparty democracies however. Authoritarian regimes can face a similar set of problems in the wake of financial liberalization and opening; and it is upon such a case that the next chapter will focus.

¹⁵⁴ David Murray, "Thailand's Recent Electoral Reforms," *Electoral Studies*, Vol. 17, No. 4 (December 1998), 526

Chapter 5

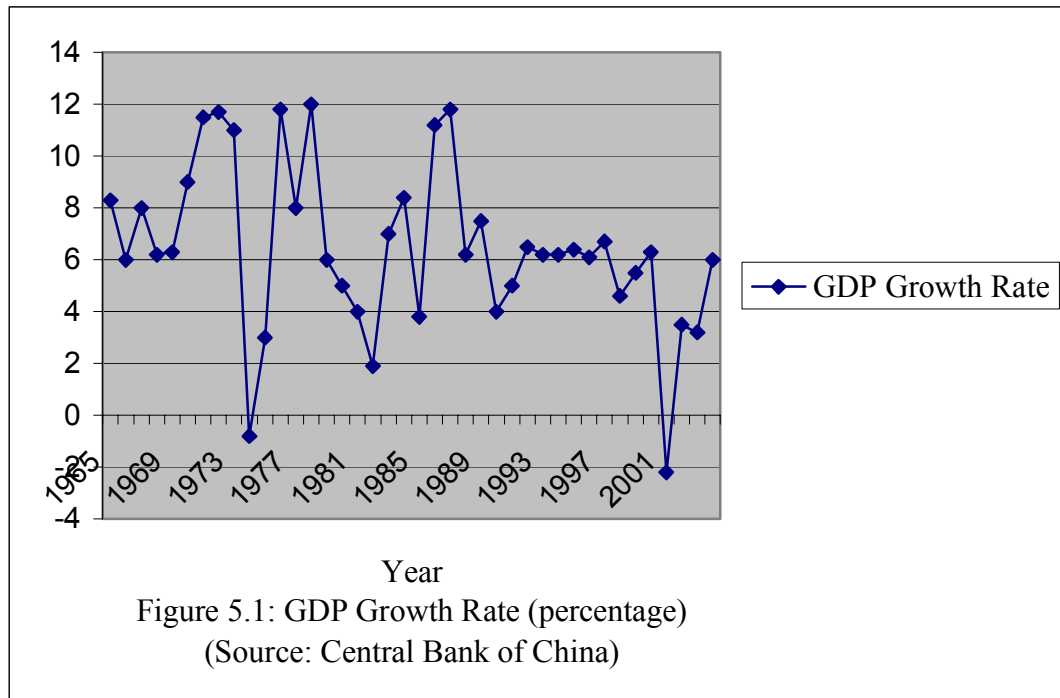
Taiwan Invulnerable

Financial Authority and the Politics of Regulatory Discipline

5.1 Introduction

The stability of Taiwan's banking system during the Asian financial crisis of 1997 represents an important puzzle for the theory of regulatory politics. The majority of the literature that seeks to explain Taiwan's survival of the regional financial crisis focuses upon Taiwan's robust macroeconomic position as well as its flexible industrial organization. However, Taiwan's trade balance and financial sector deteriorated considerably between 1997 and 2002, and yet Taiwan's banking system recovered without the outbreak of a system-wide crisis. Because few studies have researched the manner in which Taiwan's regulatory system distributes the costs and benefits of financial regulation, most observers have ignored the fact that Taiwan has been confronting challenges to the stability of its financial sector from the first moments of its inception.

Taiwan is an important case for testing the hypothetical expectations of the contract-theoretic model developed in chapter two because the model predicts that financial regulation will always have distributive consequences for the members of Taiwanese society and so any equilibrium that is negotiated between bank managers and government regulators, or that is imposed by government fiat, will be temporary and ultimately unstable. The primary source of financial instability in Taiwan's history was the conflict between the KMT and the native Taiwanese over control of the credit market, which occurred within the context of the broader conflict between Taiwan and mainland China.



As figure 5.1 illustrates, Taiwan's economic growth has been punctuated by periods of high growth as well as frequent economic downturns. According to the argument outlined in chapter two, the irregular cyclical pattern of Taiwan's growth trajectory can in part be explained by conflict over control of the positive and negative externalities of the banking system. Furthermore, I argue that distributional conflict over the banking system created a dynamic that forced the nationalist government, and later the DPP-led government, to continuously adjust their regulatory policies. And so even when the financial markets were functioning most "efficiently", between 1989 to 1994, the entry of the native Taiwanese into the formal credit market resulted in a struggle between the native Taiwanese business community and the KMT, as each group sought to re-adjust the allocation of the costs and benefits of financial regulation in such a manner as to make a stable regulatory trajectory impossible to preserve.

Taiwan is also an important case because it did not succumb to the regional financial crisis in 1997. The resilience of Taiwan's banking system following the

collapse of the regional financial system in Asia, as well as Taiwan's ability to cope with the regulatory risks associated with capital outflows to mainland China in the 1990s, serve as an illustration of the conditions under which the government can credibly commit to the observance of prudential regulatory standards in the financial environment of the open economy.

A "first cut" overview of Taiwan's regulatory history is represented in Table 5.1. The table reveals that Taiwan has witnessed several minor or mini-crises throughout its history; such as the financial disturbances that followed the diplomatic crisis of 1979, during the underground credit crisis in 1988, during the cross straits crisis in 1994, and finally, following the Asian regional crisis in 1997. Hence, rather than a set of systemic mega-crises, such as those experienced Asia in 1997 or such as was observed in Mexico in 1982 and 1994; Taiwan instead experienced a set of contained implosions of parts or segments of its financial sector. Why does the Taiwanese pattern of financial crisis diverge so distinctively from that of other economies?

Contrary to arguments that are currently popular within the political economy literature, the relative ability of Taiwan's regulators to preserve prudential banking standards was not the result of the institutional delegation of regulatory authority to an independent government agency. The Taiwanese model is based instead upon the creation of multiple regulatory institutions, none of which claimed legal independence from Taiwan's central government.

In accordance with the formal model presented in chapter two, bank managers obeyed prudential regulatory standards when the government demonstrated its resolve to impose bankruptcy costs upon delinquent bank managers and further demonstrated that it would not hesitate to re-allocate managerial control rights when a financial crisis; which occurred following the diplomatic crisis of the 1970s, following the

bursting of the underground credit bubble in the late 1980s, and following the cross straits crisis that occurred between 1994-95.

Taiwan's financial regulators insist that a legally independent regulatory agency would not have sufficient authority to insure that Taiwan's bank managers abide by prudential standards, nor would an independent agency have the authority to respond to the domestic financial consequences of Taiwan's unstable security environment. The regulatory model that evolved and currently functions in Taiwan relies instead upon a pre-emptive strategy, wherein regulatory authorities intervene into the financial sector at the first sign of financial distress in order to prevent a systemic crisis.

Pre-emptive corrective action enables Taiwan's financial regulators to induce a contained implosion of a segment of the financial sector without threatening overall systemic stability. However, pre-emption was an option for Taiwan's financial regulators only because of the *non-delegation* of executive decision-making power over the enforcement of regulatory prescriptions. Indeed, "pre-emption" in Taiwan often occurred during periods of violent repression of political movements led by native Taiwanese that challenged the financial dominance of the KMT. And so any explanation of Taiwan's ability to resist the fate of other Asian countries in 1997 would require a deeper understanding of the manner in which regulatory authority was exerted against the remainder of society, and the precise manner in which the Taiwanese government allocated bankruptcy costs and managerial liability during the post-intervention rehabilitation process.

The social distribution of the costs and benefits of financial regulation over the course of Taiwan's history is represented in Table 5.1 below. In accordance with the theoretical framework developed in chapter two, Taiwan's regulatory history is resolved into six regulatory scenarios that are sub-divided into conceptual categories that represent the credit allocation decisions of bank managers as well as the type of

corrective regulatory actions taken by public authorities in response to the credit allocation decisions of bank managers. As a consequence of the actions of bank managers and public regulators, the costs and benefits of financial regulation are distributed between the Taiwanese government, the taxpayers, Taiwan's commercial bank managers, and finally, the banking sector's minority shareholders.

Regulatory Prejudice. The first regulatory scenario represents the period between 1949 and 1979, during which Chang-Kai shek and the Kuomintang party (KMT) re-organized the banking system to serve the nationalist struggle against communism. The nationalist government strongly believed that that financial regulation was imperative for Taiwan's national security, and consequently, the governance model that evolved during the first precarious decades granted the government maximum control over domestic banks and over the credit allocated to the different sectors of Taiwanese society. The resulting monopoly over the allocation of credit allowed the nationalist government to extract a rent from the domestic savings pool that was consistent with the "financial repression" paradigm of bank governance.

Regulatory Failure. The second regulatory scenario represents the period between 1979 and 1987, which describes the regulatory problems that emerged during the presidential tenure of Chiang Ching-kuo, when Taiwan suffered the loss of its international legal status and during which Taiwan experienced a period of asset inflation and witnessed the growth of an underground credit market. The third scenario depicts the distributional consequences of the financial crisis of 1988. The financial crisis was the direct result of government's exclusion of the Taiwanese business community from the formal credit market, who responded to the government's credit discrimination by creating an unofficial, and ultimately unstable, underground credit market.

Table 5.1: Competing Theories of Financial Crisis in Taiwan

	<u>Economic Outcome</u>	<u>Geo-strategic Shocks</u>	<u>C.B. Independence</u>	<u>Distributional Conflict</u>
1949-60s	Economic Crisis	KMT expelled from mainland U.S. support	No central bank until 1961 15 government agencies Cold War	Bank of Taiwan and “Big Three” banks supervise banks dominate financial sector KMT dominates native Taiwanese
1970s-87	Financial Repression	Loss of Intl. status Diplomatic Crisis	CBC controlled by the Executive branch	Native Taiwanese create underground financial market
1988-94	Financial Crisis 1993-95 Black Gold Crisis	China-Taiwan rapprochement	Financial market Reforms BMA/CDIC established	Native Taiwanese establish banks Native/KMT compete
1995-96	Financial Crisis 5 Bank runs and stock market crash	Cross Straits Crisis	No central bank independence CDIC expanded	Government bails out financial sector
1997-2004	Financial Crisis	Asian Financial Crisis Global Slowdown	Anti-corruption campaign	DPP takes power More banks est. KMT banks prosecuted electoral corruptio

Regulatory Discipline. The fourth and fifth scenarios represented in Table 5.2, correspond to the periods during which Taiwan's regulatory apparatus adapted to the challenges of the Lee Tung-hui administration, during which the government initiated political and financial reforms that enfranchised the native Taiwanese, both politically and financially, and relaxed the rules that governed capital account transactions. The financial sector remained stable during the early reform period, but the entry of banks owned by native Taiwanese in 1991 represented the first direct challenge to the KMT's hold over Taiwan's financial sector. The ensuing struggle taxed the regulatory competence of the Central Bank of China as well as the newly created Bureau for Monetary Affairs, which was devoted exclusively to the examination of banks.

The fifth regulatory scenario of Table 5.2 depicts the period between 1993 and 1997, and examines how electoral reforms and financial liberalization interacted in the 1990s created a market for electoral corruption that endangered the soundness of the non-bank financial sector. As Taiwan's regulators scrambled to contain the financial consequences of increasingly intense competition between the KMT and its electoral competitors, a new source of financial sector vulnerability emerged in the form of outward flow of investment capital to mainland China during the 1990s. The magnitude of the capital outflows taxed the regulatory competence of Taiwan's regulators and threatened to alter the security balance between Taiwan and mainland China. Finally, scenario six of Table 5.2 corresponds to the rise to power of the Democratic People's Party (DPP) in 1999, which launched an anti-corruption campaign that successfully targeted the bank managers who were most responsible for the financial corruption of the KMT era.

Taiwan was able to preserve monetary stability despite all of these challenges, only because the regulatory apparatus could summon the political authority of the executive branch of Taiwan's government in order to intervene in the affairs of the

politically most sensitive financial institutions. Hence, although monetary instability was pronounced during the cross straits diplomatic crisis of 1995 as well as during the Asian financial crisis in 1997, the multiple institutions that perform the regulatory function in Taiwan were able overcome the conflict between credit expansion and the requirements of prudential regulation that afflicted the Bank of Thailand during the 1990s.

5.2: Financial Authority and National Security

Taiwan's banking system traces its origins to financial institutions founded by the Japanese occupation and to banks established by Chiang Kai-shek and the KMT. Because the nationalist government viewed the financial sector as the primary engine of economic growth as well as a potential source of vulnerability, the entire banking system remained under government ownership until the 1970s. As Taiwan's diplomatic position deteriorated steadily in the 1960s and 1970s, the political conflict between native Taiwanese and the mainland politicians who controlled the government intensified. Consequently, the pre-liberalization regulatory system was designed to exert maximum control over lending practices of bankers, in order to preserve mainlander control over the financial sector and as a way of guarding Taiwan's economic security from the depredations of financial mismanagement. Until 1961, the Bank of Taiwan performed the regulatory function in Taiwan.

Table 5.2 The Social Distribution of the Costs and Benefits of Regulatory Action in Taiwan, 1949 – 2004

<u>Regulatory Scenario</u>	<u>Bank Status</u>	<u>Regulatory Action</u>	<u>Economic Outcome</u>	<u>Taxpayers</u>	<u>Bank Managers</u>	<u>Shareholders</u>
(1) 1949-1979	Wealthy	Forbear	Financial Repression	Budget Surplus	KMT collects rents	Well Capitalized
(2) 1980-1987	Bankrupt	Forbear	Asset Inflation Illegal Financing	Surplus Deficit (1988)	Underground financial market	Government bailout (1980-86)
(3) 1988	Bankrupt	Intervene*	Stabilization	Reg. Cost	Criminal Prosecution	Government Reorganization
(4) 1989-1992	Solvent*	Forbear*	Stable Markets Financial Sector	Balanced Budget	Banking Liberalization	Native Taiwanese enfranchisement
(5) 1993-1997	Bankrupt	Forbear	Black Gold Cross-straits	Budget Deficit	KMT vote-buying	KMT bailed-out
(6) 1998-2004	Wealthy	Intervene*	Financial Instability Surplus	Deficit (1998-2000)	Criminal Prosecution KMT/DPP (1998-00)	Government Reorganization

Once the Central Bank of China was re-incorporated in 1961, the central bank was invested with the authority to conduct both monetary policy and banking regulation. The Central Bank of China was not above internal bureaucratic struggles however, and in 1979, the central bank had to endure the demotion of its bureaucratic status. The government was also forced to reassess the viability of excluding the native Taiwanese business community from the formal banking sector following widespread financial crisis in the 1980s. In response to the crisis, the government extended public supervision over the non-bank financial sector and initiated a set of governance reforms that anticipated many of the challenges that Taiwan would ultimately have to face in the financial environment of the open economy.

5.21 Power Politics and the Banking System

In December 1949, the government of the Republic of China (R.O.C.) was exiled from mainland China to the island of Formosa. Subsequently, the financial sector was re-organized and unified under the control of the KMT. The organizational philosophy of the KMT as well as the existential challenge posed by communist China required that all banks and much of the economy remain under government control. Taiwan's security imperative translated domestically into the dominance of KMT mainlanders over native Taiwanese and gave rise to a hybrid governance model that combined multiple channels of government control over the economy with performance incentives similar to those of the private sector. Hence, until the economic reforms of the 1980s, all major Taiwanese banks and financial institutions were owned and managed by the KMT, the provincial government of Taiwan, or the central government of the Republic of China.

In 1895, the Japanese founded the Taiwan Osaka Chung Li Bank, which was the first western style bank in Taiwan. By 1908, when the Imperial Bank of China

was first established on the mainland, there were already seven banks operating in Taiwan. The Japanese also authorized credit cooperatives and the credit departments of agricultural and fishing associations to serve the rural areas of Formosa. In 1897 the Japanese Parliament passed the Taiwanese Banking Law that established the Bank of Taiwan and authorized that bank to issue and circulate local bank notes. Due to Japanese efforts, by the end of the occupation in 1945 there were five major indigenous banks operating in Taiwan; the Bank of Taiwan (1897), the Chang Hua Bank (1905), the Taiwan Commercial and Industrial Bank (1910), the Hua Nan Bank (1919), and the Taiwan Savings Bank (1921). Credit cooperatives also proliferated during the Japanese occupation, increasing from 16 cooperatives in 1913, to 252 by 1916, and reaching a total of 498 cooperatives by the end of 1942.

After the Japanese withdrawal in 1945, Chiang Kai-shek transferred control of the financial institutions established during the Japanese occupation to the Provincial Administration of Taiwan.¹⁵⁵ The reorganization of the financial sector was part of the nationalist government's overall grand strategy that conceived of Taiwan as a base for reclaiming the mainland from the Communist control. The nationalist vision required that the KMT exercise preponderant control over the resources of Taiwan, and so the provincial government established new specialized industrial banks that answered only to the Provincial Council. By the early 1950s, as the result of the nationalization of the Japanese era banks and through the incorporation of new banks, the provincial government controlled approximately 90 percent of all economic activity in Taiwan.¹⁵⁶

¹⁵⁵ Lawrence L.C. Lee, *The Development of Banking in Taiwan: The Historical Impact on Future Challenges*, Occasional Papers in Contemporary Asian Studies, No. 6 (149) (College Park: University of Maryland School of Law, 1998), 13. On October 31, 1945, the Ministry of Finance also promulgated the Regulation Governing the Liquidation of the Private Financial Institutions in Taiwan Province ("liquidation regulation").

¹⁵⁶ Lee, Lawrence L.C., *The Development of Banking in Taiwan: The Historical Impact on future challenges*, Occasional Papers, No. 6 (149), (University of Maryland School of Law, 1998),

The principal function of the financial sector in the 1950s was to support state-owned import substitution industries (ISI) through financing the importation of capital goods. The state owned banks were the primary means of financing specific industries or firms associated with government policies. Control of the credit market also gave the KMT an effective way of maintaining the party's dominance over the indigenous Taiwanese by denying local businessmen access to financing. The center of the financial sector during the ISI era was the Bank of Taiwan, which performed the function of a commercial bank and also acted the central bank. The Bank of Taiwan issued currency and was the primary instrument of government-directed credit policies, and when required, the Bank of Taiwan even operated as lender of last resort.¹⁵⁷

The shift from ISI policies to an export led strategy as well as the termination of U.S. economic aid in 1958 compelled the government to expand the financial sector. As part of the regime's new development strategy, the Central Bank of China was reopened in 1961 and new financial institutions were established to finance development projects. Although preferential credit allocation diminished in the 1960s, the government maintained authority over the reform process by granting foreign banks only limited access to the domestic market and by strictly controlling the rate of growth of private financial institutions.¹⁵⁸ Initially, local capitalists were only permitted to retain control of the urban credit cooperatives that were chartered during the colonial period. In the 1950s, the government licensed only 7 privately owned mutual loan and savings institutions. Local entrepreneurs were permitted to open insurance companies in the 1960s but were not authorized to own controlling shares in trust and investment companies until the 1970s.¹⁵⁹ By 1980, the seven

¹⁵⁷ Lee, Ibid,

¹⁵⁸ Tun-jen Cheng, "Guarding the Commanding Heights: The State as Banker in Taiwan, in Stephan Haggard ed., *The Politics of Finance in Developing Countries* (Ithaca: Cornell University Press, 1993), 63

¹⁵⁹ Cheng, "Guarding the Commanding Heights", 74-75

government commercial banks still accounted for almost 90 percent of total bank deposits, while the privately owned banks held only 5 percent of total deposits.¹⁶⁰

The earliest governance model that developed in Taiwan was a product of the province's unique economic and security environment. The nationalists conceived of banks as the key to economic security and so the government and ruling party maintained strict control over the governing boards of the major banks. The chairman of the board and the senior board members of each commercial bank were often ex-ministry of finance and central bank officials who were appointed directly by the premier's office or by the provincial government. The nationalist government appointed the senior staff of each bank and even determined the internal salary scales and annual bonuses within the commercial banks that were regulated by various arms of the government.¹⁶¹ The final component of the state dominated financial sector was the regulatory and supervisory system, which was designed in such a manner as to insure the obedience of bank managers to the regime's ideological goals and organizational philosophy.

4.21 The Institutional Foundations of Regulatory Discipline

Taiwan's political institutions are strongly influenced by the nationalist struggle against communism and by the ongoing confrontation with the People's Republic of China. The Taiwanese regulatory system is no exception. The regulatory apparatus is a hybrid system that draws upon influences that are as diverse as the political philosophy of Dr. Sun Yat Sen, the nationalist government's experience with hyperinflation and financial crisis on the mainland during the 1930s, and even the

¹⁶⁰ Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990), 161

¹⁶¹ Wade, *Governing the Market*, 161

infrastructure created by the Japanese occupation government. The post-1949 regulatory system is also a product of the KMT's historical obsession with political control of the economy, which is reflected in the labyrinthine authority structure of the economic bureaucracy.¹⁶²

According to Taiwan's constitution, the country's most powerful political institution is the President of the Republic. The remainder of the central government is organized within the five "yuans," which are the branches of the national government. The Legislative Yuan is the primary law making body in Taiwan, and among its many responsibilities, the legislative body appoints the members of the Executive Yuan. The Executive Yuan consists of the Cabinet, and the Office of the Premier, who presides over the Executive Yuan.¹⁶³ The ministries, agencies, and commissions responsible for economic governance are generally contained within the Executive Yuan, and as a general rule, the President appoints the cabinet and premier. The third and fourth branches of government are the Judicial Yuan and the Control Yuan respectively, which interpret the constitution, adjudicate civil and criminal trials, and in the case of the Control Yuan, applies censures against government officials who have behaved illegally or unethically.¹⁶⁴

The constitution also grants the central government the highest level of statutory authority over the financial sector. The financial powers of the central government include legal jurisdiction over the entire banking system, control of the

¹⁶² Cheng, "Guarding the Commanding Heights", 77; The KMT's determination to directly control the banking sector was also informed by the memory of the treachery suffered at the hands of financiers during the civil war period on the mainland. During the final years of the wartime period (1943-1945), private banks colluded with merchants in order to collect rents from credit allocation, to hoard commodities for speculative purposes, and to profit from inflationary prices. The result the banker's conspiracy was a period of hyperinflation and financial crisis that undermined the nationalist government's political legitimacy. The experience with hyperinflation on the mainland led the KMT regime to conclude that private bankers could not be trusted with the implementation of a stable monetary policy.

¹⁶³ The Premier also serves as a liaison between the executive branch of government and the President's Office.

¹⁶⁴ Denny Roy, *Taiwan: A Political History* (Ithaca: Cornell University Press, 2003), 84; Wade, *Governing the Market*, 196; The members of the Control Yuan are generally named and appointed by the provincial and city governments. Until the 1999 presidential elections, the president's position as the KMT party leader combined with the party's dominance of official positions gave the president powers that overwhelmed the formal institutional balance between the branches of government.

monetary and exchange rate system, as well as full managerial responsibility for the state-owned enterprises and financial institutions. Although the Provincial Government of Taiwan is constitutionally subordinate to the central government, the provincial government retains administrative jurisdiction over local townships. As depicted in Table 5.3, until the government privatization efforts in the 1990s, the provincial government also exercised controlling interest in the banks, businesses, or credit cooperatives that were owned by the sub-national governmental units.

Bureaucratic controls illustrated in Figure 5.2 meant that all Taiwanese financial institutions are further beholden to the Executive Yuan, to which Taiwan's regulatory institutions formally report, as well as to the Civil Code and the Banking Law, which are enforced by the Control Yuan, the Provincial Government, the Judicial Yuan, and the government offices responsible for legal prosecution. In all, until the financial reforms of the late 1980s, state owned banks were monitored and supervised by a total of fifteen government agencies.¹⁶⁵

Taiwan's elaborate regulatory system succeeded in moderating risk taking by bank managers to the extent that many outside observers have noted that Taiwan's state-owned banks are managed like "pawn-shops." The most severe of the government's regulations were associated with writing-off non-performing loans. Given that bank managers and their staff were legally designated as civil servants, any bank officers who approved loans that became non-performing were held personally liable for the loss and were therefore subject to administrative penalties as well as criminal prosecution.

¹⁶⁵ Until 1998, Taiwan's three leading commercial banks, Chang Hwa, Hua Nan, and First Commercial Bank, were owned by the Ministry of Finance, managed by the Department of Finance of the Taiwan Provincial Government, supervised by the central bank, overseen by the Control Yuan, audited by the Legislative Yuan and the Provincial Assembly, budgeted by the Director General of Auditing, Budget and Statistics, and under the Personnel Bureau of the Executive Yuan for personnel management. For every bank, the appointment of top level personnel for example the president or chairperson, need approval from at least six agencies, whereas budgets need approval from four agencies.

Prudential restrictions also limited unsecured loans to 25 percent of an institution's total deposits and imposed a six month maturity limit upon unsecured loans and a one year limit upon secured loans. Furthermore, the central bank and finance ministry strictly monitored any loans with maturities beyond the one-year limit. Although the statutory limitations upon the type of loans a bank could advance were relaxed in 1968 and largely removed in 1975, managerial constraints governing the internal operations of banks were strictly maintained. Prudential regulatory constraints also served distributive functions, which created rent-seeking opportunities for KMT insiders. Until the reforms of the late 1980s, for instance, regulatory limitations granted the KMT government a near monopoly over the domestic credit market and to thereby prevent the native Taiwanese from establishing private banks.

Instead, the government pursued a policy that preserved the state dominance of the banking sector. In order to meet increased demand for credit, in 1958, the government re-established four financial institutions that had once operated on the mainland. The provincial government also increased the *guanxiye*'s access to credit in the early 1970s by permitting native Taiwanese to establish six trust and investment companies (TICs). More importantly, in 1976 the provincial government opened the Medium Enterprise Bank (TMEB) and between 1977 and 1979, the government approved seven licenses for privately owned and regionally operated medium enterprise banks.

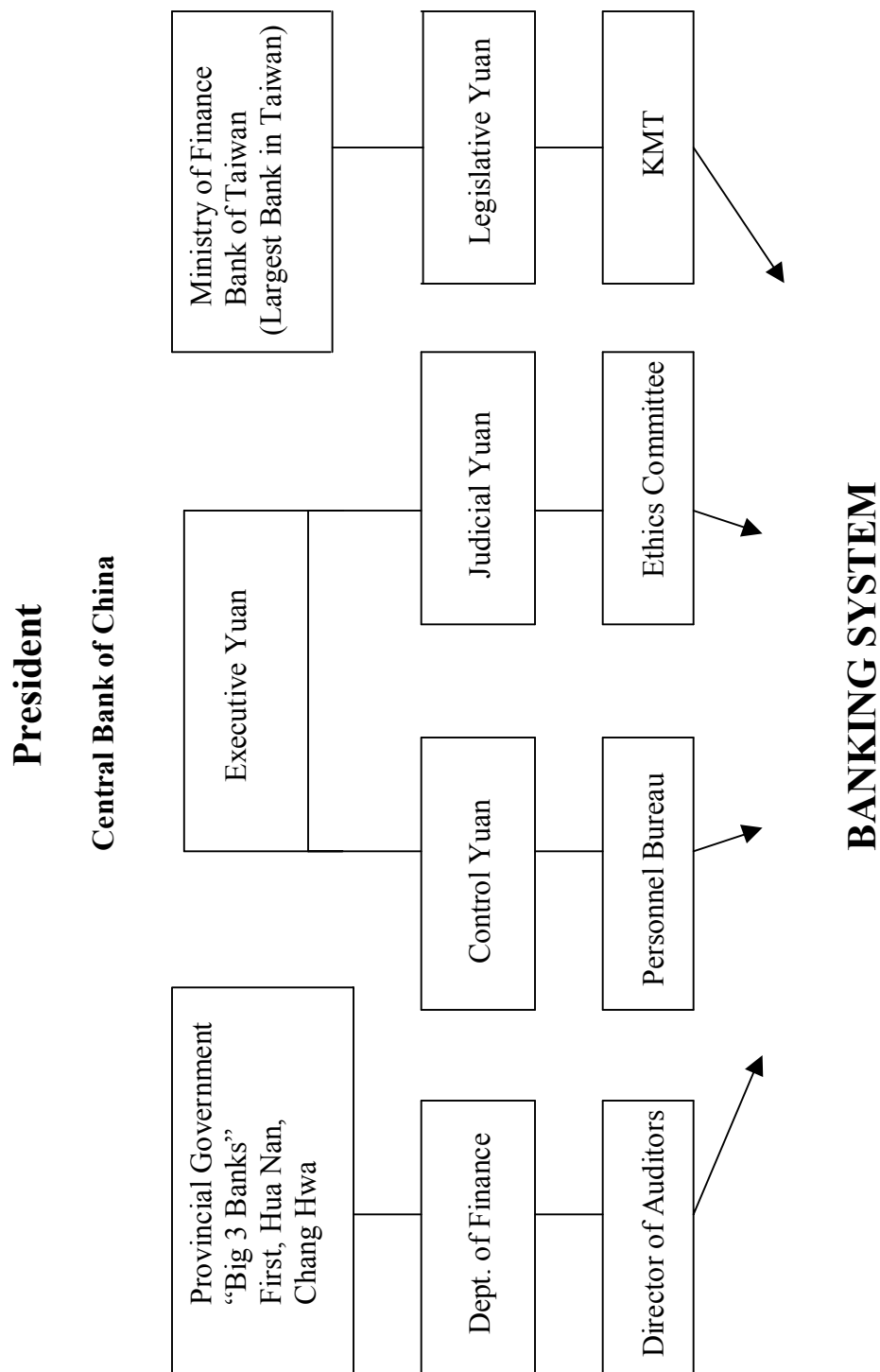


Figure 5.2: Bureaucratic Supervision of the Banking System in Taiwan, 1949 - 1990

While more substantial native Taiwanese ownership of commercial banks would have to await the reforms of the late 1980s, the government cultivated foreign participation in the domestic banking sector more actively. In 1972, the government granted a group of overseas Chinese permission to open the United World Chinese Commercial Bank. Taiwan's leadership also opened the domestic credit market to ten western banks between 1972 and 1976, eight of which were American multinational banks.

Over the 1970s, Taiwan's balance of payments became consistently positive. Despite the oil shock of 1973, which caused a recession between 1974 and 1975, foreign exchange surpluses continued to accumulate. Government stabilization policies and an appreciation of the Japanese yen also helped Taiwan reach a GDP growth rate of 4.9 percent in 1975, and by 1977, Taiwan once again enjoyed trade surpluses.¹⁶⁶ In 1974, the KMT sought to stimulate economic activity by initiating "Ten Major Construction Projects" which cost the government US \$5.8 billion. The projects included the Kaoshiung Shipyard (4 percent), steel mills (17.6 percent), petrochemical facilities (15.4 percent) Taoyuan International Airport, and several railroad and seaport projects.¹⁶⁷ The domestic economy responded strongly to the fiscal stimulus of the government infrastructure projects, and so by the late 1970s, Taiwan had accumulated sufficient assets to become a capital-exporting country.

Although Taiwan's economic growth rates had long outpaced nearly all of the developing economies, Taiwan's economic success could not prevent the outbreak of a series of political and economic crises that were to test the limits of the country's resilience. The first crisis began on October 25th 1975, when the United Nations General Assembly voted to transfer the Security Council seat once held by Taiwan to

¹⁶⁶ Frank S.T. Hsiao and Mei-Chu W. Hsiao, "Taiwanese Economic Development and Foreign Trade," in John Y.T. Kuark, ed, *Comparative Asian Economies* (London: JAI Press, 1996), 251

¹⁶⁷ Hsiao and Hsiao, *Comparative Asian Economies*, 251-252

the People's Republic of China. Due to the loss of its international status, Taiwan was forced to relinquish its membership in the UN's member agencies, including the International Monetary Fund and the World Bank. The loss of diplomatic recognition forced Taiwan's leadership to develop its own economic strategy, and although the lack of multilateral participation denied Taiwan access to several diplomatic resources, Taiwan was nevertheless free to pursue its own schedule in terms of the sequencing and timing of financial liberalization.

The second domestic crisis was precipitated by the death of Chiang Kai-shek on April 5th, 1975. Chiang Kai-shek's son, Chiang Ching-kuo, succeeded his father and served the final two years of the former president's term. There was only weak domestic opposition to the succession and so Chiang Ching-kuo was re-elected to the presidency by the National Assembly in March 21, 1978.¹⁶⁸ A much more severe blow to Taiwan's international position was sustained when the United States re-opened its diplomatic relations with Communist China. Although the Korean War and the war in Vietnam had made Taiwan a valuable America ally, in December 1979, the United States sacrificed its diplomatic recognition of Taiwan in order to achieve the greater geo-strategic goal of separating mainland China from the Soviet Union.¹⁶⁹

The political and economic crisis of the 1970s did not dampen the intensity of domestic political struggles however, and even the central bank was not above inter-bureaucratic conflict. Between 1961 and 1979, the Central Bank of China held a pre-imminent position within the economic bureaucracy, which was signified by the fact that the central bank answered directly to the President of the Republic. However, following the constitutional reforms of 1979, the central bank's status was reduced to a level equal to that of the finance ministry and was thereafter required to report to the premier's office (Executive Yuan). Ironically, the central bank's demotion was

¹⁶⁸ Roy, Taiwan, 156

¹⁶⁹ Interview, Taipei, October 2000

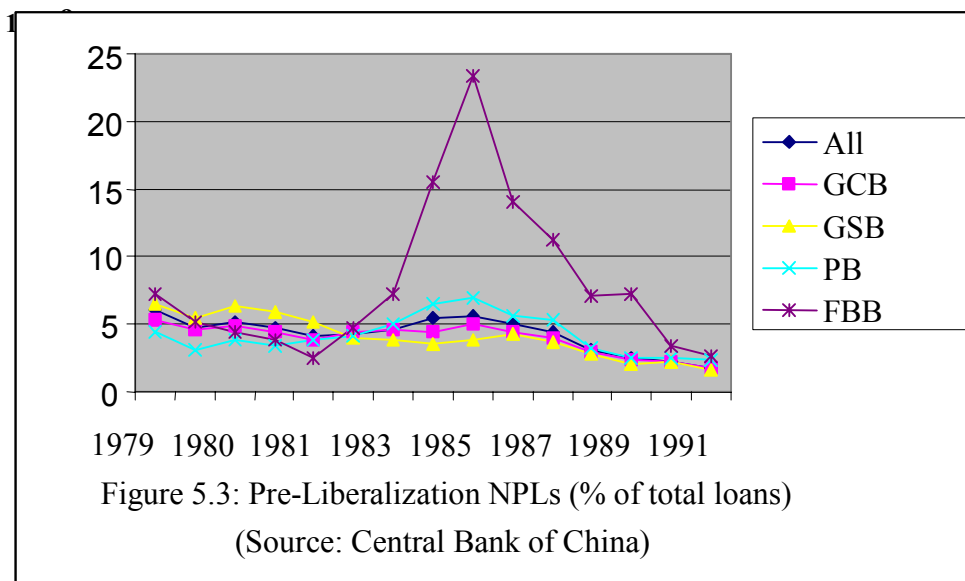
followed by the final crisis of the Chiang Ching-kuo era, which erupted as the result of asset price inflation and the uncontrolled expansion of Taiwan's underground financial sector.

The underground financial sector emerged as a result of a loophole in the Banking Law, which did not clearly state the exclusive rights of banks to accept deposits and loan funds. Although the state owned-banks still accounted for 90 percent of total deposits by 1980, the native Taiwanese businesses were still excluded from full participation in the formal credit market, and so the *guanxiye* developed a curb market that circumvented the government's regulatory authority. Thus, between 1965 and 1988, the curb market supplied an average of 35 percent of total loans granted through the financial system. During the 1950s, the curb market offered loans at rates 300 percent higher than bank loan rates, but by the 1970s, curb market lending rates were only 50 to 100 percent higher than the loan rates of the government banks.¹⁷⁰

The unbridled expansion of the informal credit market came to an abrupt halt in the mid-1980s, when the underground financial sector became a source of financial distress and public scandal. The non-performing loans generated by the underground crisis are depicted in Figure 5.3. The underground sector consisted of loan sharks, underground investment companies, post-dated check discounters, and rotating credit clubs; entities which were beyond the reach of the formal regulatory system. The underground investment companies (UICs) achieved prominence in 1986 and 1987 when they created major economic and financial difficulties. Hung Yuan, the largest of the UICs and 170 smaller UICs were estimated to hold NT\$8 billion for over one

¹⁷⁰ Shea, *Financial Sector Development in the Republic of China, Taipei*, in *Financial Sector Development in Asian Economies* (); Wade, *Governing the Market*, 160-161. Between 1976 and 1981 the private sector is estimated to have received about 60 percent of their financing from banks, while the public sector received 96 percent of their financing from banks.

million investors in Taiwan.¹⁷¹ The UICs also engaged in stock manipulation and insider trading.



Legend: GCB = Government Commercial Banks, FBB = Finance Bureaus,
GSB = Government Savings Banks, PB = Public Banks

The first scandal involved the Tenth Credit Coop (TCC), which was the largest financial crisis faced by the R.O.C. government since 1949. The TCC was bought by the Tsai Wan-chun family in 1957 and was transformed into the largest credit co-op by the mid 1970s. TCC even surpassed commercial and several medium enterprise banks in terms of deposits held. Criminal activity began in 1966 and by 1974 it became obvious that TCC family enterprises were receiving an unacceptably high portion of total loans, despite the fact that government regulations not only forbid extending loans to corporations but further disallowed overextension to a single firm or conglomerate.¹⁷²

¹⁷¹ Lee, *The Development of Banking in Taiwan*, 19

¹⁷² Cheng, *Op. Cit.*, 82

In 1985, when TCC debt became unmanageable, the government extended a NT \$30 billion emergency loan that failed to quell a deposit run on TCC. When the Ministry of Finance discontinued its liquidity support, the TCC failed, causing the Cathay Plastics conglomerate to declare bankruptcy. The failure of the TCC and Cathay Plastics sent shockwaves throughout the financial and corporate sectors that affected Cathay TIC, several industrial firms (including Tatung Electronics), and disrupted the operations of three Trust and Investment Companies. Eventually, the TCC and several related firms and industrial conglomerates. The collapse of TCC sent shock waves to three bills and finance companies and nearly bankrupted Cathay Trust and Investment. The political consequences of the TCC crisis reached as high as the top echelons of the Ministry of Finance and also forced several government ministers to resign.¹⁷³

The financial devastation caused by the underground credit crisis also revealed weaknesses in Taiwan's regulatory system as well as within the national system of corporate governance. In order to redress the regulatory shortfall, the government established the Central Depository Insurance Corporation (CDIC) in 1985 and sponsored further institutional innovations that were meant to strengthen the government's authority over the financial sector. By 1989, the UICs had attracted between NT\$ 200 – NT\$ 300 billion in capital, which were invested in speculative real estate and stock ventures. The speculative nature of the UICs meant that they would inevitably become a regulatory problem and so the Ministry of Finance engaged in a pre-emptive intervention in 1988.¹⁷⁴

Beyond the regulatory implications, the underground crisis demonstrated the danger of excluding native Taiwanese businessmen from full access to the formal credit market and caused the KMT to question the wisdom of the state-monopoly over

¹⁷³ Cheng, *Op. Cit.*, 83-84

¹⁷⁴ *Ibid*, 85

the banking sector. In retrospect, there is little question that the state-dominated banking system was one of the primary reasons that enabled Taiwan to increase its per capita income from US\$500 in 1950 to US\$11,000 in 1990, and in fact, it was precisely Taiwan's spectacular economic success and relative political stability that allowed the country's leadership to consider systematic institutional reforms for the first time.

5.3 Financial Authority in the Open Economy

Beginning in the late 1980s, Taiwan's leadership initiated a set of reforms that transformed Taiwan from an autocracy whose banking sector was owned and managed by the government into an open economy that is governed by a multiparty democracy. Although political and financial reforms were implemented concurrently, the timing and sequencing of the reforms were constrained by Taiwan's legacy of administrative caution, the regulatory consequences of electoral reform, and by the reality of Taiwan's international position. Consequently, the financial authority of the central government was challenged; first by the regulatory implications of electoral competition between the KMT and its domestic rivals, and then by the uncertainty generated by the unstable dynamic of Taiwan's financial and security environment.

By the mid-1980s, mainland China had adopted a policy of "peaceful offense" towards Taiwan, which contrasted sharply with the military confrontation that punctuated cross straits relations in the 1950s and 1960s. Fundamental disagreements persisted however, regarding Taiwan's legal status and the ultimate destiny of Taiwan-mainland relations. Mainland China insisted upon a "One China, two systems" policy, which Taipei viewed as tantamount to the legal subordination of Taiwan's sovereignty to the PRC. In response to Beijing's pressure, Taipei countered with a "One China, two governments" initiative, which presumably freed Taiwan to

seek international recognition and strengthened Taipei's bargaining position over the final terms of political re-unification. Hence, the seeming relaxation of cross strait relations created opportunities as well as new strategic challenges for both Taiwan and the PRC.¹⁷⁵

Once détente had been established between Beijing and Taipei, Chiang Ching-kuo initiated the most sweeping political reforms since martial law had been declared in 1950. The 1986 constitutional reforms did not legitimize opposition parties, but Chiang did permit non-KMT members to participate in legislative elections for the first time in 1986, and revoked martial law in February 1987. Soon afterwards in January 1988, Chiang Ching-kuo died, and after some internal KMT controversy, Lee Tung Hui became President of the Republic in 1988. Lee not only accelerated the electoral reform process, legalizing open competition for all seats of the Provincial Assembly and Legislative Yuan for the first time in 1992, but furthermore, President Lee inaugurated a period of systematic financial liberalization with a revision of the primary banking law in July 1989.¹⁷⁶

The financial reform process culminated in July 1991, when the government-approved licenses for the establishment of 16 new banks whose major shareholders were private conglomerates owned by native Taiwanese. As part of the liberalization process, the government strengthened its formal statutory powers over the financial sector by establishing the Bureau of Monetary Affairs (BMA) in 1991 and by augmenting the examination capability of the CDIC and the Central Bank of China, in order to intensify government supervision of the financial sector.¹⁷⁷

¹⁷⁵ Chang, Tun-jen and Peggy Pei-chen Chang, *Limits of Statecraft: Taiwan's Political Economy under Lee Tung Hui*, (St. Mary's College: Unpublished paper, 2002), 40-45

¹⁷⁶ Roy, *Taiwan*, 164-175; Chao and Myers, *The First Chinese Democracy*, 221-227; For financial liberalization see: Semkow, Brian W., *Taiwan's Financial Markets and Institutions: The Legal and Financial Issues of Deregulation and Internationalization*, (New York: Quorum Books, 1992), 89-95

¹⁷⁷ *Annual Report*, Bureau of Monetary Affairs (Taipei: Ministry of Finance, 2000)

The introduction of the new banks in 1991 created three groups of domestic commercial banks; the old public banks, the specialized business banks, and the new private banks, each of which was managed by a distinct corporate culture. The new private banks in particular hired away the most talented managers from the older banks and adopted both personnel and management policies from the multinational banks. Within the new credit market there is a great deal of variety in terms of management strategies, but with regards to risk assessment and internal control mechanisms, the overall level of non performing loans increased dramatically from an average of 1 percent of total loans in 1988 to an average 4.8 percent in 1998. Compared to the banking sector, the credit cooperatives and local credit associations had even fewer constraints upon irresponsible and risky lending, and therefore suffered from much higher levels of failed loans.¹⁷⁸

The deteriorating risk profile of Taiwanese financial institutions was largely a consequence of the erosion of the once strictly enforced firewall between financial regulation and legislative politics. The electoral reforms of the 1990s allowed business conglomerates that were once excluded from economic policymaking to more directly lobby the government, through campaign contributions as well as through fielding candidates in the legislative elections. In fact, Lee Tung Hui himself cultivated the support of Taiwanese business groups as part of his attempt to balance the “non-mainstream” elements of the KMT who staunchly opposed his presidency. Upon reaching legislative positions, pro-banking sector candidates were quick to gain seats on the powerful finance committees, enabling the banking sector to influence financial legislation as well as the appointment of officials to the governing boards of the primary regulatory institutions.¹⁷⁹

¹⁷⁸ Interviews by the author, Taipei, Taiwan, September 2000; and, *Banking and Regulation in Asia and the Pacific Countries*, 101

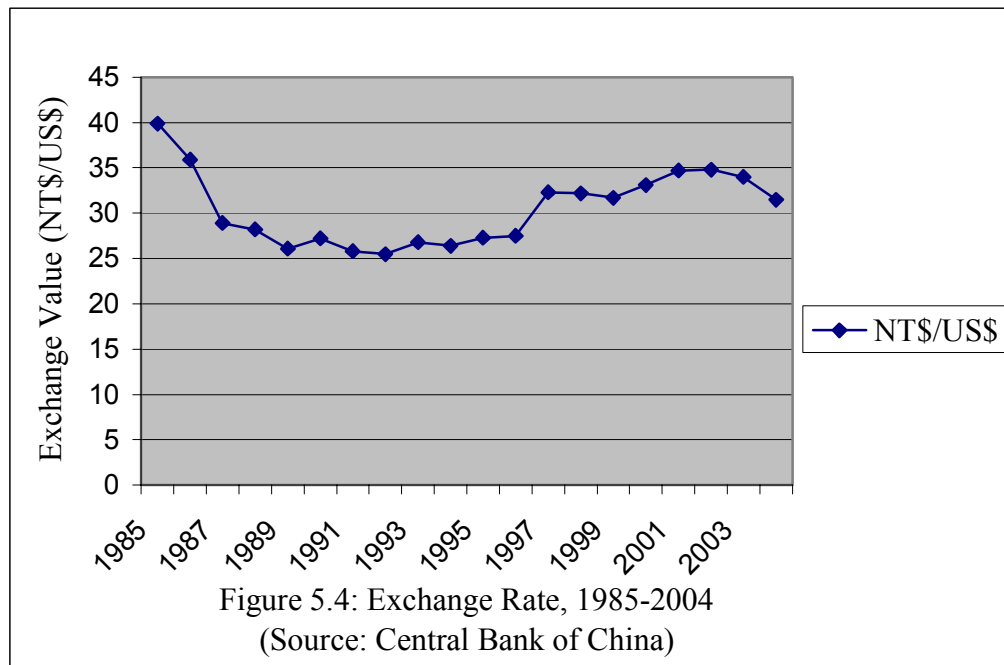
¹⁷⁹ *New Financial Politics*, and Chang and Chang, *The Limits of Statecraft*,

Electoral competition also created a steady demand for campaign financing, which granted financial institutions even greater power to affect the outcome of legislative elections. Taiwan's largest electoral districts are multi-member constituencies, and electoral outcomes in all of the districts are calculated according to the single non-transferable vote (SNTV). The organization of the Taiwanese electorate allows each party to centrally control the distribution of parliamentary seats but also forces candidates from the same party to compete for campaign financing and to vie for votes within the same district. As electoral competition between the KMT and the Democratic People's Party (DPP) continued in the 1995 and 1999 legislative elections, banks and credit cooperatives became the main source of funds for campaign financing as well as for illicit activities such as vote buying. Illegal election tactics and speculative investments associated with KMT candidates were described as "black gold" by the popular media, and increased in direct proportion to the intensification of electoral competition. Hence, the supervisory demands upon government agencies charged with overseeing the financial sector increased dramatically in the 1990s, because of the expanding number of banks and also because of the regulatory consequences of electoral reform.

The most significant constraint upon the economic bureaucracy however remained Taiwan's international political reality. The general relaxation of tensions between the superpowers following the end of the cold war in Europe refocused international attention upon the unresolved political conflict between Taiwan and the PRC. Within the new security environment, the PRC adopted a global strategy that was designed to "check Taiwan militarily, attract Taiwan economically, and blockade Taiwan diplomatically."¹⁸⁰ Implicit to Beijing's strategy was granting Taiwan access to the mainland's vast markets as a way of increasing Taiwan's economic dependence

¹⁸⁰ Chang and Chang, *The Limits of Statecraft*, pp.33-34

upon the PRC. The Taiwanese government responded cautiously to mainland China's policy and sought to restrict cross straits investment while expanding Taipei's international efforts to secure diplomatic recognition. Thus, as Taiwanese investments flowed to China in increasingly larger waves during the 1990s, the diplomatic competition between Beijing and Taipei also intensified; creating sufficient political tensions to precipitate the cross-straits crisis of 1995-1996.¹⁸¹



As Figure 5.4 illustrates, the government was successful in dampening exchange rate volatility. However, the cross-straits crisis caused widespread monetary instability in Taiwan's asset markets as well as in the domestic credit market, which forced the government to rethink its financial strategy. As an immediate response to the deposit runs that followed the crisis, the CDIC initiated a deposit insurance

¹⁸¹ Zhao, Suisheng, "Economic Interdependence and Political Divergence", In: Suisheng Zhao, editor: *Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis*, (New York: Routledge Press, 1999), 32-35

program in 1995 and dramatically expanded its examination of the non-bank financial sector. The government also renewed its emphasis upon financial regulation and supervision as a means of controlling the international investment activities of Taiwanese conglomerates. In 1996, Lee Tung Hui announced a “Go slow, be patient” policy which was designed to reduce Taiwanese dependence upon Chinese markets by moderating the flow of investment funds to the mainland. Finally, the government established four “stabilization funds” that were intended to insulate the financial sector from the effects of international shocks such as those experienced during the cross-straits crisis.¹⁸²

The re-assertion of the economic bureaucracy’s authority over the financial sector coincided with the initial stages of the Asian financial crisis in 1996. The macroeconomic strength of Taiwan was thus fortified by the government’s ability, through the multiple regulatory agencies, to protect the banking sector from the most devastating effects of the regional financial crisis. Although the monetary and banking system came under stress in late 1997, the central bank quickly deployed its US\$85 billion in foreign exchange reserves in order to guard the monetary system against speculative pressures. Moreover, Taiwan’s experience with financial crisis in the late 1980s and the monetary instability generated by the cross-straits crisis had forced the regulatory apparatus to anticipate future external shocks. Nor were Taiwan’s banks permitted access to external debt markets to the extent of banks in other Asian economies. The many years of regulatory discipline and unending political crisis between Taipei and Beijing had well prepared Taiwanese bank managers for the rigors of the open economy. And so despite an increase in the level

¹⁸² Chang and Chang, *The Limits of Statecraft*, Wang, Jiann-Chyuan, “Taiwan and the Asian Financial Crisis,” In Chow, Peter C.Y. and Bates Gill editors, *Weathering the Storm: Taiwan, Its Neighbors, and the Asian Financial Crisis*, (Washington D.C.: The Brookings Institution, 2001),

of non-performing loans and a weakened financial sector, Taiwan remained invulnerable to the ultimate effects of the regional financial crisis.

5.31 Governing Banks: Financial Liberalization and National Security

In July 1988, the central committee of the KMT elected Lee Tung Hui President of the Republic of China. Because of his native Taiwanese origins, Lee's ascension to power was initially resisted by several military commanders and by the leaders of the party bureaucracy.¹⁸³ After the 1990 presidential elections, President Lee reorganized the party hierarchy and encouraged electoral reform, in part to weaken the hold of the older party bureaucracy upon the legislative institutions.¹⁸⁴ The native Taiwanese business community, excluded from meaningful political participation since the foundation of the republic, enthusiastically responded to President Lee's request for support. Hence, the systematic financial reforms that began in 1988 were an integral part of Lee Tung Hui's broader plan to reorganize the institutional foundations of the Taiwanese government.¹⁸⁵

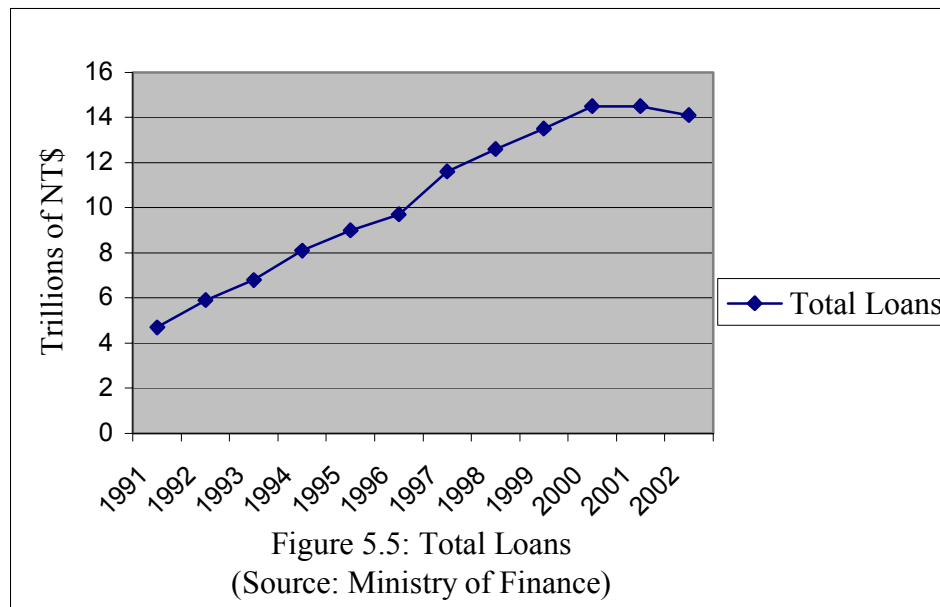
Financial liberalization in Taiwan began with the gradual deregulation of interest rates in 1980, and so by 1989, the broad spectrum of interest rates was ostensibly determined within the credit market. In 1988, the government initiated a reform of stock brokerage firms as the first phase of the wider liberalization effort. The next step was the revision of the banking law in July 1989, which affected one third of all legal provisions that governed the banking sector and removed the licensing restrictions for opening new banks, thereby permitting native Taiwanese to participate fully in the banking sector for the first time. By September 1989, nineteen

¹⁸³ In order to circumscribe Lee's authority, the party leadership imposed their own candidates for vice-president and premier upon Lee during the 1990 presidential elections, and in the early years of his tenure, Lee could not rely upon the loyalty of the intelligence services or the military establishment.

¹⁸⁴ Chang and Chang, *The Limits of Statecraft, and the First Chinese Democracy*

¹⁸⁵ Semkow, Brian, *Taiwan's Capital Market Reform: The Financial and Legal Issues*, (Oxford: Clarendon Press, 1994),

applications for the establishment of new banks had been submitted to the Ministry of Finance, which approved the licenses of sixteen new banks in early 1991.¹⁸⁶



The financial reforms expanded the commercial banking sector by 50 percent and as a result, the introduction of the new private banks into the credit market altered the overall system of corporate governance. The most immediate effect the new banks was a relaxation of the once strictly enforced credit constraint upon the *guanxiqiye* and the larger family owned conglomerates.¹⁸⁷ The expansion in credit is depicted in Figure 5.5. With the emergence of a new source of bank financing, private businesses were freed from one of the most powerful instruments that the government had once

¹⁸⁶ Further amendments of the bank law in 1993 allowed banks to engage in securities underwriting and to issue short term debt instruments, and from 1994, the regulations administering bill-financing companies were also relaxed. Banks were afterwards permitted to trade in derivatives, to privately deal in bonds and to provide fee-based consultancy services.

¹⁸⁷ Fields, Karl, *Enterprise and the State in Korea and Taiwan*, (Ithaca: Cornell University Press, 1995), . In 1992, small and medium sized businesses accounted for over 97 percent of the companies in Taiwan and accounted for over 40 percent of total production. Prior to the banking reforms, small and medium sized firms relied on domestic financial institutions for only 39 percent of their total external financing, which was slightly lower than the average conglomerate level of 42 percent.

used to contain the expansion and political influence of private business groups. Beyond the new banks, financial reforms also created an over-the-counter (OTC) market for corporate securities that allowed Taiwanese firms to raise US\$27.6 billion in domestic asset markets and US\$8.9 billion internationally.¹⁸⁸ Consequently, the government could no longer easily dominate native Taiwanese business groups, and had to instead employ more subtle regulatory policies to influence corporate decisions.

The looming challenges of the new credit market were not unanticipated, and although restrictions upon the participation of native Taiwanese in the economy and political system had become obsolete, the legacy of regulatory caution engendered by the KMT's obsession with financial security survived the liberalization process. Accordingly, as depicted in Figure 5.6, the economic bureaucracy and the more conservative legislators moved to strengthen the primary regulatory agencies. Simultaneous to approving new bank licenses, the Ministry of Finance upgraded its monetary department in July 1991 to form the Bureau of Monetary Affairs, which allowed the finance ministry to engage in financial examination for the first time. The forty bank examiners employed by the Bureau of Monetary Affairs after 1991 focused exclusively upon the new private banks. In 1991, the government announced a CDIC administered deposit insurance program that by 1992 was covering 68 percent of deposits in private institutions and 13 percent of deposits in the government owned banks. Finally, the financial examination department of the Central Bank of China was expanded in 1991, and in 1996, the CDIC doubled the number of its financial examiners.¹⁸⁹

¹⁸⁸ Semkow, *Taiwan's Capital Market Reform*, pg. 22

¹⁸⁹ Interviews by the author, Taipei, Taiwan, October 2000

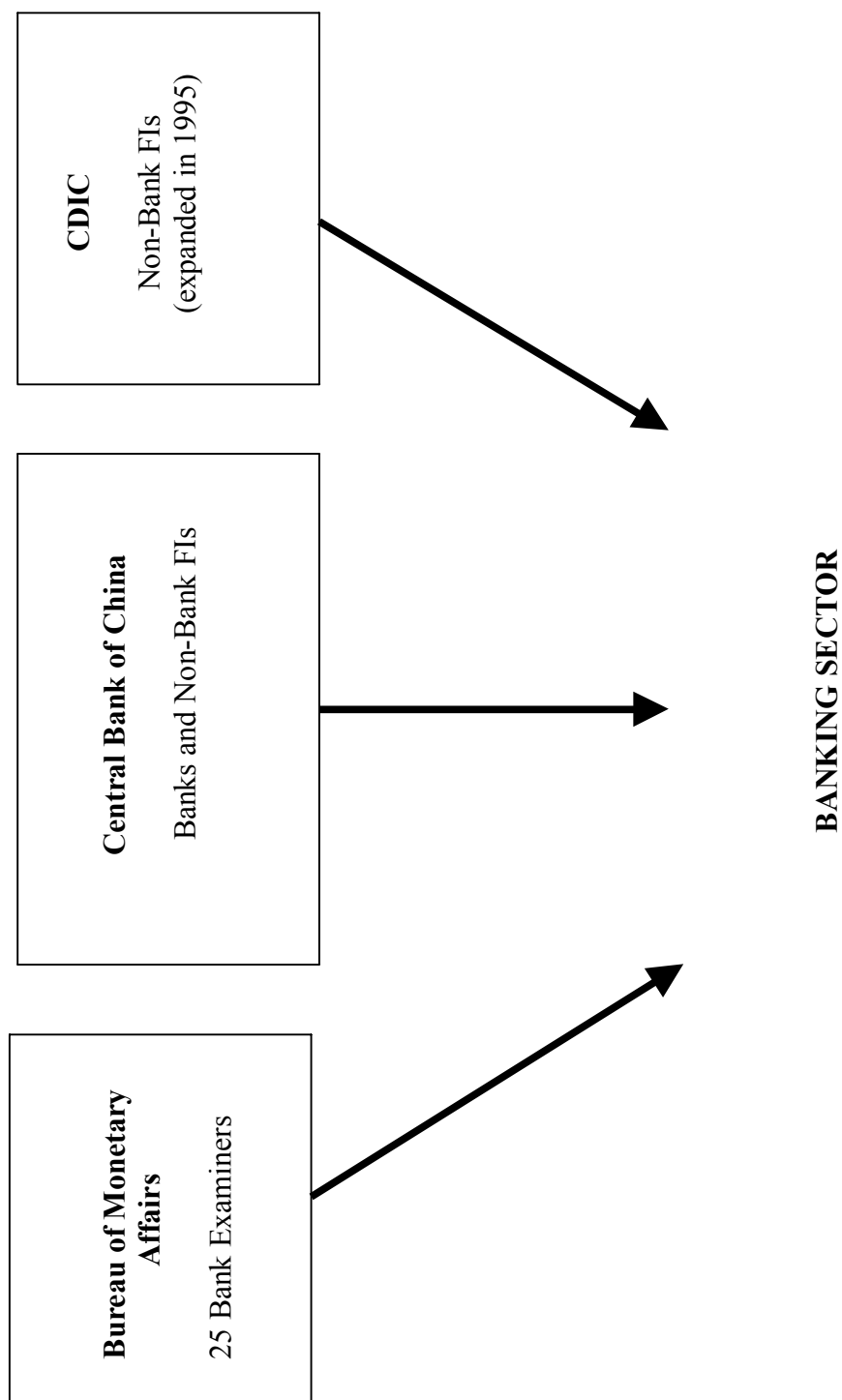


Figure 5.6: Regulatory Institutions in Taiwan, 1990 - Present

In 1992 the Central Bank of China moved to further strengthen its regulatory command over the foreign exchange system in order to neutralize external sources of monetary instability. Domestic banks were now compelled to notify the central bank of any foreign exchange transactions in excess of US\$100,000, and until the end of 1996, the central Bank of China required all banks to limit their derivative transactions to a level below 33 percent of their total foreign exchange position. The central bank also resisted the internationalization of the Taiwanese currency by restricting ownership of foreign assets and by placing limits upon the extent to which banks could hold foreign liabilities.¹⁹⁰ As a result, any domestic bank that wanted to engage in short term foreign borrowing had to first overcome the many regulatory hurdles imposed by the Central Bank of China. In fact, the central bank's dominance over Taiwan's foreign exchange market was so complete that one senior bank officer remarked: "The central bank *is* the FX market."¹⁹¹

As of December 1994, there were a total of 58 domestic commercial banks in the Taiwanese credit market; which consisted of 13 government-owned banks, nine specialized business banks, and the 16 new commercial banks.¹⁹² Due to the expansion of the banking sector, there are now a wide variety of management models governing the manner in which banks extend credit, manage risk, and enforce regulatory statutes.

Credit allocation within the Taiwanese credit market is based upon a graduated scale of authority within each bank, and as is the case of Thai banks, the board of governors controls the most significant loans. Government banks include the Bank of

¹⁹⁰ Chu, Yun-han, "Surviving the East Asian Financial Storm: The Political Foundation of Taiwan's Economic Resilience," in T.J.Pempel, editor: *The Politics of the Asian Financial Crisis* (Ithaca: Cornell University Press, 2000),

¹⁹¹ Ho, Szu-yin and Jih-chu Lee. *The Political Economy of Local Banking in Taiwan*, (Unpublished manuscript, National Chengchi University, 1999), 6

¹⁹² *Central Banking: Special Edition*, (Taipei: Central Bank of China), 28. By 1994, there were 483 financial institutions, which together had 3,975 branches, and so the government was required to examine and supervise 4,278 financial units in total. The central bank directly supervised 1,232 units, the finance ministry monitored 781 units and the CDIC was responsible for 2,265 units.

Taiwan, the largest of the commercial banks, and the Central Trust of China; each of which are 100 percent government owned. The asset portfolios of government banks range in value from US\$3 billion to US\$55 billion (average asset value of US\$25 billion). Within the Bank of Taiwan, the president of the bank can approve loans up to a NT\$150 million limit, but larger loans require the approval of the board of governors.¹⁹³ The credit allocation policies within the Central Trust of China, by contrast, require that loans above the NT\$50 million to be approved by the bank's board of governors.¹⁹⁴ Until 1998, the provincial government also retained full ownership of "the big three": Chung Hua Bank, Hua Nan Bank and First Commercial Bank, which together account for 20 percent of Taiwan's loan market.¹⁹⁵ Despite the great variety in term of overall performance within public sector banks, the share of the loan market held by the government banks between 1992 and 1997 fell from 74 percent to 60 percent.¹⁹⁶

The specialized business banks consist of four public banks and five privately controlled banks, such as the International Bank of Taiwan. Despite the financial reforms of the early 1990s, the government continues to impose both geographic limitations and credit requirements upon the specialized banks. The Ministry of Finance has divided Taiwan into six banking districts and the Central Bank of China allows only one specialized bank per district. Each of the specialized banks is also required to allocate 70 percent of their loan portfolio to small and medium sized enterprises, and in return, the geographic restrictions permit each specialized banks to

¹⁹³ Interview by the author, Taipei, Taiwan, September, 2000

¹⁹⁴ Interview by the author, Taipei, Taiwan, October, 2000

¹⁹⁵ According to article 7 of the banking law, the state owned banks are held accountable according to the Ministry of Finance's strict credit policies and personal liability rules that force individual bank officers to take responsibility for any mistakes. The board of governors of the Bank of Taiwan or the Central Trust of China, like that of all government banks, is appointed by the Ministry of Finance in consultation with the Premier's office.

¹⁹⁶ Casserley, Dominic, *Banking in Asia: The End of Entitlement*, (Singapore: John Wiley & Sons, 1999), The state owned bank's share of deposits also shrank from market share deposits for state owned banks dropped from 56 in 1992 percent to 47 percent by 1996

extract an oligopolistic rent from its respective district.¹⁹⁷ In the wake of financial reforms, the nine specialized regional banks also witnessed a decline in their share of the loan market, from 13 percent in 1991 to 11 percent in 1997.¹⁹⁸

By far the most dynamic segment of the banking sector consists of the 18 new private banks, which include E Sun Bank, Union Bank, En Tie Bank, Bank Sinopac, and Cosmos Bank. According to Table 5.3, each new bank is associated with a family owned conglomerate that generally controls the appointment of the managers and the directors of the new banks.¹⁹⁹ Although there is a great deal of diversity in terms of the private bank's managerial models, the bank system survey in Appendix B reveals that the governing boards of Taiwan's private banks generally control the approval of any loan applications above the \$NT 100 range. For instance, according to E Sun's management model, loans above NT\$ 80 million require the approval of the central credit committee. Within Union Bank, which is owned by the same conglomerate as E Sun bank, any secured loan greater than NT \$ 70 million and any unsecured loan greater than NT \$ 20 million, requires the approval of the credit examination committee. The Taiwanese banking sector also contains banks that claim that their capital-asset-ratio is at least 10 percent, and a few banks, such as Bank Sinopac, even claim a capital-asset-ratio as high as 13 percent.

Because of poor accounting standards and asymmetric information, the private banks prefer long-term relationships with the largest of the conglomerates and with firms with excellent market reputations. The private banks also tend to be smaller than the government banks and therefore the new banks tend to engage in syndicated

¹⁹⁷ Interviews by the author, September, 2000; In Taipei County, for instance, the only specialized bank permitted to operate is the International Bank of Taiwan. The Ho family, who holds 15 percent of the bank's equity, and has become Taiwan's wealthiest specialized bank, manages the International Bank of Taiwan.

¹⁹⁸ Casserley, *Banking in Asia*,

¹⁹⁹ However, the Ministry of Finance can still nominate certain officers to the board of each private bank and thus the family run conglomerates are not totally free of the government's administrative guidance.

Table 5.3: Management Survey of Taiwanese Banks

	<u>Intl. Bank of Taipei</u>	<u>C. Trust of China</u>	<u>Union Bank</u>
Owner	Ho Family Merged with Bank Sinopac in 2005	Government Ministry of Finance	Lo Lin Family Centro Ban/Hung Tie Same owners for EnTie Ban
Political Connections	Formerly KMT connections Currently DPP connections	Formerly KMT connections Accused of granting politically motivated loans	DPP connections
Criminal Activity	No Evidence	Branch Managers prosecuted for KMT related illegal loans	No Evidence
NPLs	3.9 % in 2000 Bank claims 13% CAR 5.5% in 2000	5.5% in 1998 5% in 1999 3.5% in 2000	2% in 1998 2.9% in 1999
Performance Requirements	Semi-Annual Review No salary raises in 2000 3 strikes policy Exam required for promotion Conducted by Banking Instit. of Republic of China Performance related bonuses	Annual Review Pay unrelated to performance	Annual Review 4 possible grades assigned 3 rd or 4 th grade fired Pay is performance related

Table 5.3: (continued)

	<u>Intl. Bank of Taipei</u>	<u>C. Trust of China</u>	<u>Union Bank</u>
Risk Management	<p>No Risk Management Dept. by Fujin University</p> <p>Cash flow analysis required for loans over \$NT 100,000</p> <p>For \$NT 100-800,000</p> <p>Collateral is primary concern</p> <p>\$NT 70 million sector limit</p> <p>CBC rules: For 1 person, loans must be limited to < 15% of bank's tier-1 equity</p> <p>For 1 business group, loans must be limited to 40% of bank's tier-1 equity</p> <p>No industry limits imposed by the CBC</p> <p>Related firms must have collateral equal to > 40% of bank's tier-1 equity</p>	<p>No Risk Department</p> <p>Follows CBC rules</p> <p>9 limits system (see below)</p>	<p>No Risk Management Dept.</p> <p>9 limits system</p> <p>100% computerized</p> <p>Each branch responsible for risk management</p> <p>\$NT 20 million Forex exposure limit</p>
Loan Management	<p>5 Ps</p> <p>20 officers focus on credit risk</p> <p>Credit Limits:</p> <p>\$NT 20 million limit</p> <p>< 3% of tier-1 equity for each bank branch</p> <p>For \$NT 40 million, requires credit committee approval</p> <p>For any loan > 1% of tier-1 equity, must be approved by Board and CEO</p>	<p>5 Ps</p> <p>6th P – relationship with government</p>	<p>5 Ps</p> <p>120 account officers</p> <p>Exposure to real estate</p> <p>Unsecured loans</p> <p>< 1% of tier-1 equity</p>

Table 5.3: (continued)

	<u>Bank of Taiwan</u>	<u>E-Sun Bank</u>	<u>Bank Sinopac</u>
Ownership	Owned by Province until 1998 Owned by MoF since 1998	E Sun Group Dr. Yung Jen Huang	Sinopac Group
Political Connections	Performed tasks of the central bank until 1962 KMT connections	DPP related Eschews close political contacts	Former KMT connections Many of the bank's Execs. worked for Citigroup
Criminal Activity	No evidence Accused of extending politically motivated loans	No Evidence	No Evidence
NPLs	<2 % in 1998 1.5 % in 1999 2.48 % in 2000 Bank claims CAR of 18%	< 1% in 1998 < 1% in 1999 < 1% in 2000	< 1% in 1998 1.9% in 1999 < 1% in 2000 Bank claims 12% CAR
Performance	Annual Requirements Employees graded from A to C Employee is fired after two "Cs" Occurred once in 10 years 25% receive B grade 75% receive A grade Grade A = 4 months bonus	Semi-Annual Pay weakly tied to performance Employees are graded from A+ to B- 5% received A+ 60-70% received A/A- 30-40% received Bs B- grade are fired	Annual Pay is performance related 4 grades: A-D 5% receive grade of A 60% receive grade of B 30% receive grade of C 5% receive grade of D 2 Ds = fired

Table 5.3: (continued)

	<u>Bank of Taiwan</u>	<u>E-Sun Bank</u>	<u>Bank Sinopac</u>
Risk Management	Risk management – 9 limits conducted by credit dept. Concentration limit - \$NT 8.5 million for one firm	isk Management – 9 limits Credit dept. responsible 50% exposure to real estate through collateral	Risk Management Dept. Moving towards VAR 9 limits system Risk management conducted by HQ
CBC rules:	Before 1998 - Commercial bank loans must not exceed 1 year of working capital of any bank Since 1998 – Commercial bank loans are defined as loans that are equal to 3 to 5 years of working capital for any bank Cash flow analysis required by CBC for any loan that extends beyond 1 year		
Loan Management	108 branches 2 or 3 loan officers per branch HQ: 45 loan officers and 30 credit analysts VP must approve loans between \$NT 20-50 million Exec. VP must approve loans of NT\$ 80 million or above President must approve loans of NT\$ 150 million and above	40 branches 3 or 4 officers per branch HQ has 30 loan officers	Bank manager can approve loans up to NT\$ 30 million Exec. VP must approve loan above NT\$ 30 million Executive credit committee must approve loans above NT\$ 50 million Sinopac has credit rating from Moody's

(Source: Central Bank of China, Bureau of Monetary Affairs, and interviews at various banks, August-October, 2000)

loans to distribute risk more effectively. Hence, the more successful of the private banks, including E Sun bank and En Tie bank, engaged syndicated loans that totaled NT\$120 billion and NT\$ 50 billion respectively.²⁰⁰ Because of financial innovation and aggressive lending practice, the new private banks have doubled their share of the loan market from 10 percent in 1993 to 20 percent in 1997.²⁰¹

Interviews at a random sample of 10 institutions drawn from both government banks and the private banks revealed a dominant trend whereby risk management is conducted by each bank's credit department.²⁰² The "nine limits system" is an internal risk management system that imposes concentration limitations on credit allocation and a ceiling on loans to related parties.²⁰³ Although the central bank stipulates that cash flow analysis must be performed for any loans above the NT\$100 million level, there is a general consensus that for loans above the NT\$ 500 million level, the quality of the collateral that is offered as a security by a prospective customer is far more important.

According to internal surveys, approximately 90 percent of all loans extended by banks in Taiwan are fully secured by collateral. The primary reason that collateral is the main criteria used to assess potential clients is that information asymmetries within the credit market make proper assessment of a project or businesses viability nearly impossible.²⁰⁴ The opacity of the Taiwanese corporate

²⁰⁰ Interviews by the author, Taipei, Taiwan, September, 2000; see also: Semkow, *Taiwan's Capital Market Reform*, Bank main customers. Many of the conglomerates such as Formosa Group and Nanya Plastics had overlapping governing boards.

²⁰¹ Casserly, *Banking in Asia*,

²⁰² Interview by the author, Taipei, Taiwan, September, 2000

²⁰³ Banks are also governed by the 9 limit system which imposes limits upon: 1) loans to related parties, 2) loans to a single client, 3) loans to a single sector, 4) foreign exchange transactions, 5) external liabilities, 6) unsecured loans, 7) branch limits, 8) loans to a particular industry, and 9) loans to the government

Every loan officer interviewed about credit allocation also referred to the "five Ps": 1) People (i.e. reputation), 2) Purpose of the loan, 3) Payment (i.e. cash flow analysis), 4) Protection (i.e. collateral), and 5) Perspective – referring to the quality of a corporation's business plan.

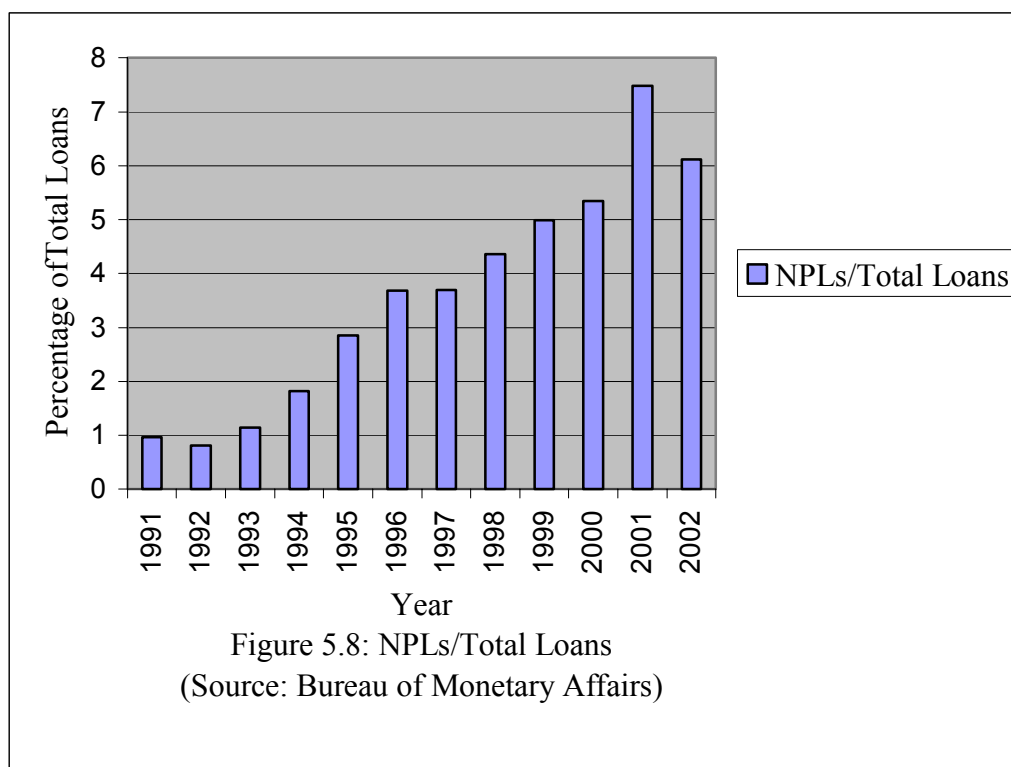
²⁰⁴ Yu, Hai-Chin, "Asymmetric Information, Collateral, and Interest Rate: The Case of Taiwan", in J. Jay Choi and John A. Doukas, editors: *Emerging Capital Markets: Financial and Investment Issues*, (London: Quorum Books, 1998),

sector is due to the inadequacy of the accounting system as well as the proliferation of techniques, such as nominee (dummy) accounts devised to circumvent government supervision of corporate transactions.

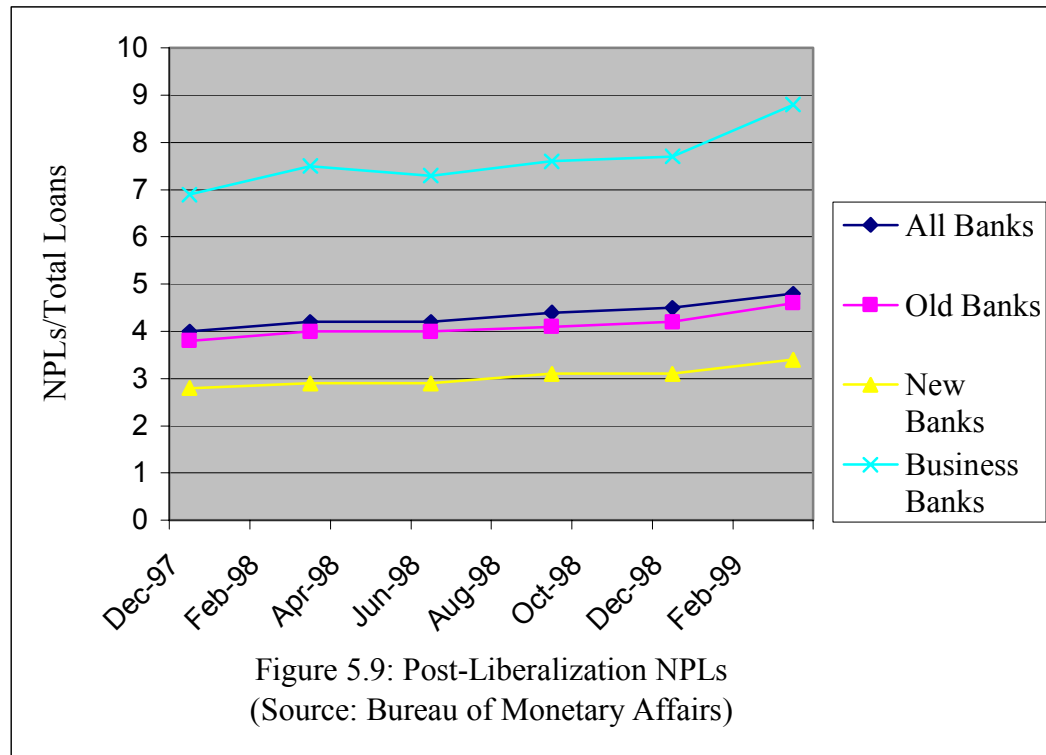
Accounting standards in Taiwan are notoriously unreliable and it is a well known principle that the small and medium sized firms keep three sets of books; one set for the tax collectors, one set for submitting to banks as part of loan applications, and a private set of accounting books for the firm's management. While Taiwan's conglomerates generally release more accurate information than the smaller firms, the fact that Taiwan's largest conglomerates own the new banks has become a primary regulatory concern.

Consequently, the central bank and finance ministry are very insistent that banks and corporations report any loans to affiliated parties or loans to shareholders on a separate evaluation report that must be submitted annually.²⁰⁵ Nevertheless, some of the private banks attempt to bypass the central government's reporting requirements by rolling over late loans, transferring non-performing assets to subsidiary firms and in some cases, by engaging in outright fraud.

²⁰⁵ Some banks claim that their related party loan procedure is more strictly regulated by internal standards than is required by the CBC. The CBC limits loans to any single person to less than 15 percent of a bank's tier-1 equity and loans to any industrial group to less than 40 percent of a bank's tier-1 equity, but there are no limits on the concentration of a bank's loan portfolio to a single industry. Related firms must secure collateral that is equal to 40 percent of a bank's tier-1 equity. If the amount of a related firm loan is greater than 1 percent of a bank's tier-1 equity, then the loan must be approved by the bank's board of governors.



The data on non-performing loans demonstrates clearly that increased competition undermined the internal control mechanism within the commercial banks that had once been so strictly enforced. Following the period of regulatory activism of the late 1980s, the overall level of NPLs exhibited a downward trend, from an average of 4 percent in 1976, to an average of 1 percent in 1991. However, as illustrated in Table 5.8, the competitive pressures and regulatory burdens of the post-liberalization era were such that non-performing loans began accumulating once more among the old government banks and in some of the new private banks. Hence, as Figure 5.8 and Figure 5.9 depict, the overall level of NPLs increased from an average of 1.5 percent in 1992 to a much higher average level of 4 percent by 1995.



The rising level of NPLs reflected deep problems with the management of some of the old government banks and several of the new banks. An important case of corruption within a government bank is that of China Trust Bank. Before the era of financial reform, credit officers within the bank enjoyed sufficient social prestige that in order to gain access to credit, prospective customers had to first develop a personal relationship with the bank's managers. Due to the unofficial credit policy, Central Trust's managers and board members became very rich from "personal donations" from potential customers. Despite the legal infractions perpetrated Central Trust's management, the judicial system was dominated by the KMT prior to political reforms and thus no action was taken to investigate Central Trust until the late 1990s.²⁰⁶

²⁰⁶ Interview by the author, Taipei, Taiwan, October, 2000

A second set of regulatory difficulties involves the chaotically managed credit cooperatives and the poorly supervised credit departments of the agricultural and fisherman's associations. The credit cooperatives are based upon broad inter-personal networks, and thus it is not surprising that among the least well managed coops, insider lending can constitute up to 150 percent of an institution's net worth. Since the 1980s, and particularly within the South and South West counties of Pinton, Towyin and Kaoshing, self-loans to managers and to their relatives and business associates have become widespread.²⁰⁷ The loose managerial control and the reluctance of regulatory authorities to intervene in the rural credit sector until the late 1990s made the regional financial institutions prime suspects for illicit campaign financing. Indeed, until the 1999 elections, political connections between rural financial institutions and local KMT representatives shielded the credit coops and rural associations from regulatory intervention, and as a consequence, a total of 29 institutions suffered deposit runs between 1995 and 1996.²⁰⁸ Inevitably, the managerial deficiencies within the credit cooperatives proved to be a threat to the stability of the rural monetary system, and so the regional credit sector eventually came under more intensive regulatory scrutiny.

A third set of challenges that confronted regulatory authorities in the post-reform era were a result of Taiwan's new security environment. In 1991, Lee Tung Hui adopted a "Go South" policy that was aimed at promoting economic and high level political relationships with South East Asian countries. However, by 1994, Taiwanese investments to mainland China outgrew total direct investment to the S.E. Asian economies.²⁰⁹ Between 1991 and 1994, the Taiwanese government

²⁰⁷ Ho and Lee, *The Political Economy of Local Banking*,

²⁰⁸ Ho and Lee, *The Political Economy of Local Banking*,

²⁰⁹ Jie, Chen, *Foreign Policy of the New Taiwan: Pragmatic Diplomacy in Southeast Asia*, (Cheltenham: Edward Elgar, 2002), Taiwan's new international policy represented the strongest diplomatic initiative since Taiwan lost its diplomatic and legal recognition 1979. Since then, it has cultivated a wide range of economic and diplomatic relationships with approximately 30 nations.

approved US\$4.6 billion in direct investment to mainland China and yet official Chinese government statistics claim that US\$24 billion in investment projects was negotiated between Taiwanese and Chinese businesses.²¹⁰ The distinction between Taiwanese and PRC figures reflects a difference in statistical definition, and more importantly, numerical discrepancies result from fact that a substantial number of native Taiwanese businesses circumvent Taipei's formal investment regulations. By 1994, there were reportedly 21,863 firms associated with Taiwanese investment spread over twenty mainland provinces, and by the end of 1995, 53 percent of Taiwanese related investments in China were fully owned by Taiwanese citizens.²¹¹

Taipei was highly sensitive to the strategic consequences of export dependence upon the mainland and to the possibility that the burgeoning value of Taiwanese investment could be used by Beijing to hold Taiwan hostage. While Taipei's ability to deter investments outside of its formal legal purview was limited, the government still held powerful regulatory instruments. In the early 1990s, Lee Tung Hui established the Mainland Affairs Council (MAC), the Straits Affairs Foundation (SAF), and the Department of Mainland Operations (DMO), in order to monitor cross-straits interactions.

With regards to the credit market, Taiwanese banks were not allowed to open branch offices in China prior to the November 1995. Of more direct importance, Taiwanese investors had no choice but to obtain the majority of their capital funds from the Taiwanese credit market (56 percent on average) that is obviously subject

²¹⁰ Leng, Tse-Kang, *The Taiwan-China Connection: Democracy and Development Across the Taiwan Straits*, (New York: Westview Press, 1998), 111-112. Difference between Chinese figures and Taiwanese figures are due to the fact that the Chinese figures represented negotiated deals that did not necessarily lead to fruition and also because many Taiwanese citizens circumvented government regulations upon investment and whose investments were thus not officially acknowledge by Taipei.

²¹¹ Leng, *The Taiwan-China Connection*, 112. The investments in the 1990s increasingly involved medium sized and large business ventures, so that by 1994, only 23 percent of total Taiwanese investments had a value of US\$1 million, compared to 37 percent in 1995.

to government regulations.²¹² Furthermore, in mid-1993, the Central Bank of China intervened aggressively in the foreign exchange market in order to bring about the depreciation of the NT\$, which was intended to redirect Taiwanese exports from mainland China to the United States. Instead of having the desired effect, exports to the U.S. declined 6.8 percent from 1992 to 1993, while indirect exports to China rose 20 percent.²¹³

The international investment behavior of Taiwanese firms would eventually become the target of more substantive policy interventions, but by the mid 1990s, cross strait investment was but one of the many worries of the economic bureaucracy. For by the mid 1990s, the regulatory consequences of electoral reforms had begun to emerge. And although the Control Yuan and Ministry of Justice set strict penalties for illegal financing practices, the lack of proper enforcement mechanisms helped create a widespread market for electoral corruption that taxed the competence of the regulatory institutions even further.

5.32 Banks and Ballots: Regulatory Consequences of Electoral Reform

The system-wide reforms initiated by Chang Ching-kuo and accelerated by Lee Tung-hui were eventually adopted by the KMT as the ruling party's formal platform. As the KMT's historical mission to re-conquer the mainland became less of a concrete possibility, it became increasingly difficult to justify the extraordinary powers of the President as well as the KMT's monopoly over the bureaucracy and Taiwan's legislative institutions. Consequently, the KMT had to formulate a reform strategy that would address the demands of native Taiwanese for greater access to political and economic resources without completely relinquishing the party's

²¹² Chang and Chang, *The Limits of Statecraft*, pg. 20

²¹³ Chang and Chang, *Ibid*, pg. 20

dominant position. Yet because the electoral and constitutional revisions successfully altered the manner in which political power and economic resources were distributed, the KMT was unable to control of the long-term outcome of the reform process.

The regulatory consequences of the political and financial reforms were predictable; the state-owned and party-owned financial institutions became the primary sources of massive vote-buying schemes and politically motivated loans as the KMT sought to maintain the party's dominance over local and national elections. The illicit and politically motivated financial activities became known as "black gold" in the local media, and due to the growth of a market for illegal campaign financing, the intensification of political competition between the KMT and its adversaries led to a general deterioration of the asset quality of the government and party-owned financial sector. Consequently the era of liberalization was also a period of distributional conflict, whose regulatory consequences were sufficiently severe to threaten the overall stability of Taiwan's financial sector.

Political reform proceeded incrementally, due to the fact that each stage of the process was violently contested, both within the KMT hierarchy as well as between the KMT and its electoral rivals. Agitation for electoral reform in Taiwan dated back to the 1970s tangwai movement, but formal recognition of the principle of competitive elections did not occur until the May 1990 decision by Taiwan's Council of Justices, that required the retirement of the legislators who had been elected on the mainland and thereby opened the way for competitive elections for Taiwan's primary legislative bodies. Consequently, competitive elections were held for the National Assembly in 1991, followed by another round of elections in the Legislative Yuan in 1992, and a third round of elections for the Control Yuan in

1993.²¹⁴ The results of the national assembly and legislature elections are depicted in Table 5.4, Table 5.5, and Table 5.6.²¹⁵

Table 5.4: Popular vote and seats in Taiwan elections, 1991-1996 (% of total vote)

	KMT	DPP	New Party	Independent
1991 National Assembly Election				
Popular vote	71.17	23.94	n.a.	4.89
Seats (percent)	78.2	20.3	n.a.	1.5
1992 Legislative Yuan Election				
Popular vote	52.51	30.79	n.a.	16.70
Seats (percent)	62.7	31.7	n.a.	5.6
1995 Legislative Yuan Election				
Popular vote	46.06	33.17	12.95	7.82
Seats (percent)	51.8	32.9	12.8	2.4
1996 National Assembly Election				
Popular vote	49.68	29.85	13.67	6.80
Seats (percent)	54.8	29.6	13.8	1.8

²¹⁴ The National Assembly also reduced its size and also shortened the term of legislators from six years to four years. According to the new laws, 225 of National Assembly members and 135 members of the Legislative Yuan would be elected directly. While 80 members of the National Assembly and 20 seats within the Legislative Yuan were appointed (as “nationwide representatives”) and 20 seats in the National Assembly and 6 seats in the Legislative Yuan are reserved for members of the overseas Chinese community. Seats in the Control Yuan and the Taiwan Provincial Assembly however, were distributed according to proportional representation.

²¹⁵ The DPP entered the elections with a platform that demanded the immediate declaration of Taiwanese independence and further constitutional revisions that would permit direct election of the president, thereby removing the last vestige of the KMT’s dominance. However, the DPP seems to have misread the electorate’s desire for an immediate declaration of independence which must have seemed radical compared to the dominant “mainstream” faction within the KMT led by Lee Tung-hui.

Table 5.5: Distribution of the popular vote in the 1994 Taiwan elections
(% of total vote)

Executive offices	KMT	DPP	New Party	Independent
Taiwan area	52.05	39.42	7.70	0.83
Taiwan Governor	56.22	38.72	4.31	0.75
Taipei Mayor	25.89	43.67	30.17	0.28
Kaohsiung Mayor	54.46	39.29	3.45	2.80
Representative offices	KMT	DPP	New Party	Independent
Taiwan area	49.16	31.71	6.09	13.04
Provincial assembly	51.03	32.54	3.74	12.69
Taipei City Council	39.48	30.41	20.83	9.28
Kaohsiung City Council	46.28	24.85	4.82	24.06

Table 5.6: Popular vote in the 1996 Taiwan presidential election (% of total vote)

	KMT (Lee-Lien)	DPP (Peng-Hsieh)	New Party (Lin-Hau)	Independent (Cheng-Wang)
Total	54.00	21.13	14.90	9.98
Taipei City	38.90	24.34	24.87	11.89
Taiwan Province	56.76	20.13	13.42	9.68
Kaohsiung City	50.62	27.32	12.77	9.29
Kinmen-Matsu	41.31	1.59	30.64	26.4

The DPP launched a campaign platform that called for Taiwanese independence, which would have at a stroke nullified Taiwan's claim to represent the entirety of the Chinese people and would have certainly brought retaliation from Beijing. The KMT, by contrast, sought to represent the ruling party as moderate and centrist, adopting a platform that promised reform but was conservative on the issue of Taiwanese independence. The KMT's electoral strategy yielded mixed results, for while the ruling party to maintain majority control of Taiwan's legislative institutions; including 78 percent of the open seats within the National Assembly, the KMT was only able to secure 62 percent of the open seats in the Legislative Yuan.²¹⁶

An explanation of the election outcome patterns displayed in Tables 5.4 – 5.6 can be found in the fact that Taiwan's electorate is divided into twelve multi-member constituencies, and elections are governed by the single non-transferable vote. Electoral outcomes and the subsequent distribution of legislative seats are distributed according to the principle of proportional representation, which favors smaller parties and creates an incentive for competition within the same party, as well as competition across parties, for votes within a single district. Consequently, although the KMT's early electoral success guaranteed the party's short term position, the legislative elections of the early 1990s transformed the manner in which political patronage was allocated, which proved ultimately devastating to the KMT's hold over Taiwanese politics.

²¹⁶ Although the first step in the political transition process was complete by 1992, Taiwan had yet to replace the temporary provisions of the martial law era with a fully articulated constitutional framework. The subsequent constitutional debate, which was inaugurated by a special session of the National Assembly convened from March to May 1992, yielded eight new constitutional amendments that permitted direct popular election of the provincial governor, county chief executives, as well as the mayors of Taipei and Kaohsiung cities. However, despite the fact that the KMT mainstream and the DPP supported the idea of direct presidential elections, the convention failed to establish a method for electing the president of the republic, largely due to the unflagging resistance from conservative KMT members to the idea of direct and popular presidential elections.

Prior to the reforms of the 1990s, the KMT had used its vast corporate and financial resources to sponsor local patronage networks that provided a wide array of services, contracts, and favors to local constituents and private businesses. The market for political patronage was thus captured by the KMT, and as a consequence, the party could simply allow local factions to compete for the party's favor, which produced a dynamic if centrally-administered system of local elections. With the advent of more open elections in the early 1990s, Taiwan's opposition groups and private business lobbies no longer had to court the KMT and could access political power more directly, thereby increasing the number of claimants upon fiscal resources and expanding the number of actors who could influence monetary policy. Hence, from a centrally controlled KMT-dominated system, access to political power under the new electoral rules was allocated according to a more competitive market for political patronage that increased the number of claimants upon the resources that were distributed by the central government. In response to the new competitive environment, the KMT expanded its vote-buying capacity, and some of the ruling party's local representatives even extended their relations with organized crime. Particularly as the DPP and other rival parties became more adept at calibrating their messages towards the electorate, the cost of gaining an electoral victory, both organizationally and financially, increased dramatically.

The first and most obvious regulatory externality generated by competitive elections was an expansion of the market for vote buying within the primary electoral districts, through which the KMT hoped to maintain its hold on power. The evidence of vote buying is only partial and impressionistic, but the overall pattern suggests that spending at the local level multiplied, particularly in Taipei and Kaoshing district. For instance, during the 1991 and 1992 legislative elections, the average KMT candidate is reported to have offered between NT\$500 to

NT\$2,000 to secure the support of an individual voter. More specifically, during the 1991 National Assembly elections, an average KMT candidate is reported to have spent between NT\$10 million and NT\$20 million (US\$400,000 – 800,000) to secure votes. Informally, it is also estimated that a Taipei district candidate required a minimum of NT\$30 million (US\$1.2 million) to secure a seat in the National Assembly through vote buying. However, other estimates state that the amount required to buy a seat in the National Assembly or Legislative Yuan ranged from NT\$50 million to NT\$100 million (US\$2million to US\$4 million). (Chao and Myers, pg. 235).

The KMT dominated market for legislative votes also extended to the level of the township and county magistrates. In the fourth district, which is dominated by Xinyuan township, each vote was sold at a price between NT\$200 for non-KMT candidates to NT\$600 (US\$23), for KMT candidates. In Wandan township, the winner of the executive office election bought last minute votes for as much as NT\$1,000. On average, each candidate is reported to have spent NT\$3.8 million (US\$150,000) just prior to the township election. And in Wandan township in total, NT\$10 million (US\$370,000) was spent on race for the township's executive office, which translates into an average of NT\$400 per vote.²¹⁷

The KMT's victories were not only a product of "black gold" politics, but were also due to the organizational capacity of the party's extensive local patronage network. The local networks were critical for the KMT's electoral performance because the patronage system not only supplied *huixuan*, which were direct monetary benefits (such as vote buying) but also provided *guanxi*, which consisted of various forms of favors, services and access to connections. According to the rules governing campaign financing, Taiwanese political candidates are permitted

²¹⁷ Bosco, 129 – 130

to spend only NT\$ 300,000 within each election and vote buying was of course illegal. However, prior to the electoral reforms the ruling party dominated the courts and Control Yuan, the institutions responsible for enforcing campaign finance rules, and thus there was no incentive for the courts to block the KMT's illegal campaign activities. The conflict of interest meant that the KMT could openly flout the anti-vote buying rules at will without any risk of accountability. Enforcement of campaign financing rules was also made difficult by the proliferation of dummy accounts, which allowed banks and political parties to transfer of funds to candidates and to local powerbrokers without detection. Since the issue of dummy accounts was not addressed until the late 1990s, enforcing the campaign financing laws was operationally intractable.

The relationship between political parties and Taiwan's business conglomerates comprised a second form of conflict of interest that proliferated during the elections of the early 1990s, which resulted in a second set of regulatory challenges that arose from the competitive elections. For instance, following the 1992 Legislative Yuan elections, a total of twenty-seven legislators had formal relationships with banks or credit unions. Among the twenty-seven legislators, twenty were shareholders of the new banks; sixteen were directors or supervisors of banks, credit unions, or other financial institutions. The trend diminished somewhat in the 1995 elections, after which only fifteen legislators were directors or supervisors of financial institutions, and in the 1998 legislative elections seated twenty-one legislators who had interests in the financial sector.²¹⁸

The total holdings of the KMT are depicted in Figure 5.8, and if the total involvement of private conglomerates in the 1992 Legislative Yuan is taken into consideration, then the overall penetration of private enterprise into legislative

²¹⁸ Chian
gtian Kuo, *The New Financial Politics in Taiwan, Thailand and Malaysia*, 22

politics is far more extensive. For instance, local factions supported 78.3 percent of all KMT candidates participating in the 1992 elections, and 82 percent of KMT candidates that were elected were associated with local factions. In fact, by the early 1990s, four members of the KMT Central Standing Committee (CSC) were leaders of the conglomerates; Koo Chen-fu of Koo's Group, Chen Tien-mao of the Kaohsiung Chen family, Kao Ching-yuan of the President Group, and Wang Yu-tseng of the China Rebar Group. (Leng, pp. 86-87). Other firms hedged their electoral chances by supporting both the KMT as well as the DPP candidates. The Evergreen Group, one of Taiwan's largest conglomerates, supported more than thirty legislators with donations ranging from US\$20,000 to US\$200,000, which included members of the dominant KMT mainstream faction as well as their primary DPP challengers. The Hualon Group is reported to have spent a total of US\$40 million to support a single candidate (Ho Chih-huei) during the 1993 county-level elections in Miaoli County.²¹⁹

The main source of the KMT's illicit campaign finance activities were the party owned firms and financial institutions, which are summarized in Table 5.10. However, the private firms also engaged in financing that went beyond the NT\$300,000 per candidate limit. Relative to their size however, the local factions that vied for power at the township and county level were by far the best financed of all the candidates of the elections of the early 1990s. Government and party banks suffered the highest level of NPLs. The most severe deterioration of asset quality occurred in the local fisherman and farmers' associations, which were the main sources of election financing at the local level, and were often the primary beneficiaries of legislative arbitrage once the candidates were successful.

²¹⁹ Up to 70 percent of candidates at the 1989 Legislative Yuan and county magistrate elections were supported by business groups. (Leng, pg. 86) Up to 70 percent of candidates at the 1989 Legislative Yuan and county magistrate elections were supported by business groups. (Leng, pg. 86)

Total Assets: US\$ 20-50 billion

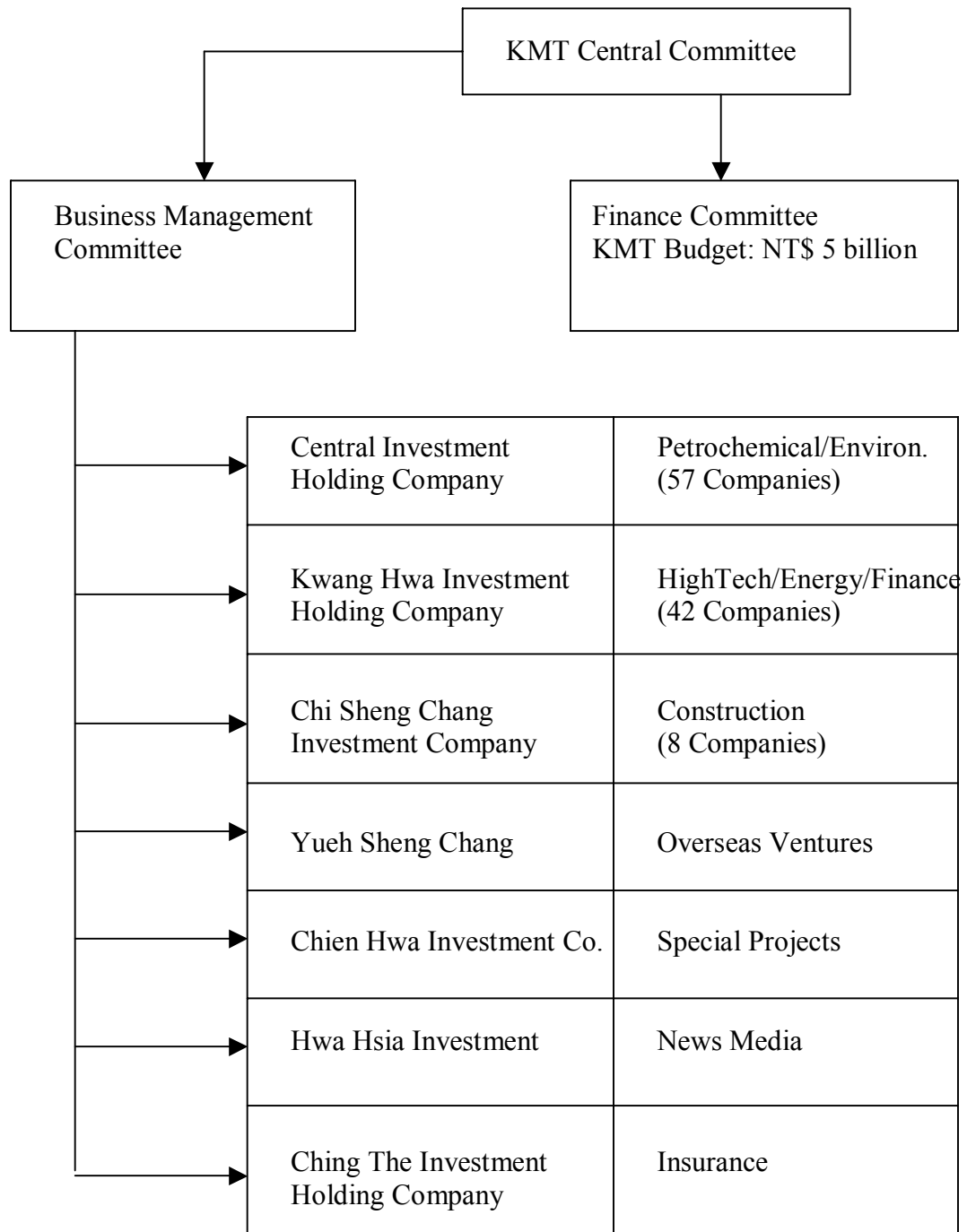


Figure 5.10: KMT Party Assets and Affiliated Corporations

In the central and southern regions, NPLs reached as high as 50 percent. According to these statistics, a large part of the local non-bank financial system is technically insolvent. By exploiting loopholes in the regulatory system, political conflict had caused deterioration of financial sector. The Presidential elections caused an equal amount of political conflict because the stakes were so high. The regulatory duties were compounded by the financial consequences of the cross crisis straits.

5.53 Taiwan Invulnerable: Surviving a Regional Financial Crisis

The presidential election of 1996 was held in the midst of the most severe cross straits diplomatic crisis that Taiwan had experienced since the direct military confrontations with mainland China in the 1960s. The domestic financial fallout from the 1995-1996 cross straits crisis included deposit runs on Taiwan's weaker banks, an intensification of stock market volatility, a brief episode of capital flight, as well as a forced devaluation of the \$NT. Undaunted by cross straits tensions, Taiwan's largest corporations continued to expand their investments in mainland China, which exposed Taiwan financial sector to internal Chinese politics and thus created another source of potential geostrategic vulnerability.

As part of the government's struggle to contain the overseas investment behavior of Taiwan's business conglomerates, legislators and regulators engaged in yet another round of institutional reforms that were designed to constrain the unprecedented rate of credit growth that followed the financial reforms of the 1990s. The reassertion of the government's control over the banking sector was intended to curtail the rising power of the native Taiwanese business community, but the government's efforts also meant that on the eve of the Asian financial crisis, Taiwan had already completed a set of regulatory and institutional reforms that

were designed to shield domestic financial markets from externally generated shocks.

The cross-straits crisis of 1995-96 brought to an end a decade of rapprochement between Taiwan and mainland China. At a regional level, the cross-straits crisis was driven by both Taipei and Beijing, as each country sought to improve its relative bargaining position with regards to Taiwan's ultimate political status. For Beijing, Taiwan's future status was non-negotiable, and so in January 1995, Chinese Premier Jiang Zemin announced an "Eight Points Plan" that invited Taipei to participate in immediate unification talks. Lee Tung-hui responded to Beijing's new initiative in March of 1995 with an alternative plan that called upon the PRC to accept the reality of an independent Taiwan. However, Lee Tung-hui's abrupt rejection of Jiang's proposal served only to convince Beijing of Taiwan's intention to more openly pursue formal independence.²²⁰ Thus, when President Lee visited the United States in June 1995, Beijing concluded that unless the PRC responded aggressively, Taiwan's movement towards independence would be difficult if not impossible to counteract.²²¹

In response to President Lee's assertive policy, Beijing adopted a stance that was intended to demonstrate that mainland China would take direct military action in order to forestall any formal moves towards Taiwanese independence. Beijing's first move came in July 1995, when the People's Liberation Army (PLA) conducted a series of missile tests within Taiwan's territorial boundaries. The U.S. responded to the escalating cross-straits tensions by sending the aircraft carrier *Nimitz* through the Taiwan Strait as a way of demonstrating America's unflagging commitment to Taiwan's security. The

²²⁰ Roy, pp. 196-7

²²¹ Zhao, Suisheng, "Introduction: Making Sense of the 1995-96 crisis in the Taiwan strait," In *Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis* (New York: Routledge Press, 1999, 7)

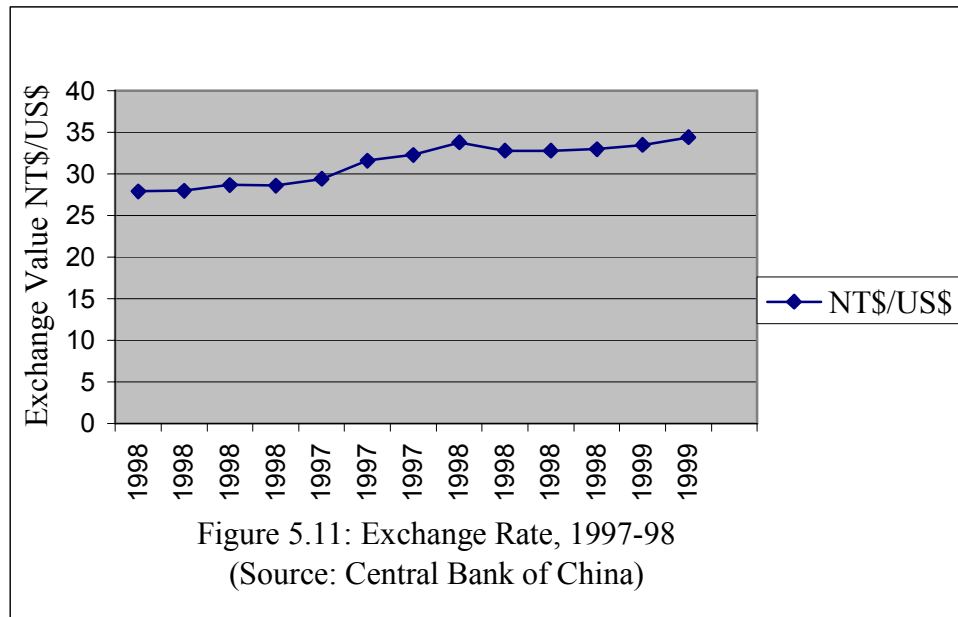
American intervention gave Beijing only temporary pause however, and in March 1996, Beijing ordered a second round of military exercises near Taiwan's Penghu Island. The United States responded by sending both the *Nimitz* and the *Independence* battle groups to Taiwan's vicinity.²²² Undaunted, mainland China launched yet another round of military exercises within the Taiwan Strait, and further conflict was averted only after delicate diplomatic negotiations assuaged the PRC's fears regarding Taiwan's future diplomatic intentions.

The financial fallout of the cross-straits crisis was largely domestic. In the months of August and September 1995 as well as March 1996, Taiwan witnessed a level of capital flight that was sufficient to precipitate a fall in the value of the NT dollar. Second order financial disturbances were also felt as a result of the decline in stock market and real estate prices. The Central Bank of China tried to quell expectations of any future devaluation by supplying large amounts of foreign exchange reserves to meet the increased demand in the foreign exchange market. During the crisis the stock market lost one third of its total value and US\$10 billion in capital flowed out of Taiwan. As illustrated in Figure 5.11 below, capital outflows caused speculative pressures to build upon the NT dollar, which eventually stabilized at NT27.5 to the US dollar.

The March 1996 missile tests also caused widespread panic selling in the securities and foreign exchange markets and also resulted in US\$ 10 billion in capital outflows.²²³ To forestall further monetary contraction, the CBC lowered the banking sector's reserve requirement in order to expand M2. Simultaneously, the CBC intervened in the foreign exchange market to quell speculative pressures and further depreciation of

²²² Roy, 199-200

²²³ Roy, 197



the NT\$, but the CBC's intervention in March 1996 also reduced foreign exchange reserves to a three year low of US\$82.5 billion.²²⁴

The level of accumulated reserves and corrective monetary measures did little to overcome the fears that domestic actors felt as a result of the cross strait tensions. Taiwan's stock exchange was the first to feel the impact of the capital flight that occurred during the diplomatic crisis as stocks plummeted to 50 of there pre-crisis levels and the financial sector as particularly hurt, experiencing the worst of the stock market collapse. The crisis' most devastating impact upon the financial sector derived not from the stock market, but from the depositor's reaction to the negative financial news. Furthermore, as Table 5.9 above reveals, 10 financial institutions experienced deposit runs during 1995. The troubles brought about by the cross-straits crisis further led to managerial steps to protect owners by looting their own institutions, which unlike other Asian countries, brought down immediate

²²⁴ The highest levels of reserves were US\$100.4 billion, which was reached in June 1995, and which exceeded Taiwan's total annual import requirements.

Table 5.7 Financial Institution Failures in Taiwan during the 1990s

<u>Failed Institution</u>	<u>Date</u>	<u>Government Response</u>	<u>Violated Statutes</u>	<u>Withdrawn Deposits</u>
Chung Ching, Tai Kai, D. Kang	1999-2000	Firm's executives arrested on Corruption charges	Corruption	NT\$ 30 million
Ching Lee Credit Coop	1998	Merged with Taiwan Provincial Farmers Assoc.	Insider Lending	None
Taiwan Coop Bank	1997	Merged with Community Financial Institution	Corruption	None
Tai Tun Medium Business Bank	02/12/96	Bailouts from CDIC and changed Director	Over-loan Affiliate Loan	NT\$330 million (28.2% of deposits)
Overseas Chinese Commercial Bank	12/12/95	Bailout by CDIC and State-owned banks	Insider Lending	NT\$513 million (16.3% of deposits)
Chungli Farmers' Association	09/20/95	Bailout by State- owned institutions	Bad Loans	NT\$3.2 billion

Table 5.9 (continued)

<u>Failed Institution</u>	<u>Date</u>	<u>Government Response</u>	<u>Violated Statutes</u>	<u>Withdrawn Deposits</u>
Chang Hua 4 th Credit Union	08/95	Takeover by the state-owned banks	Bank Fraud	NT\$6.4 billion
Intl. Bills Finance Co.	4/08/95	Financial Fraud ^d (problem loans)	Embezzlement	NT\$10.2 billion
Hou-pi Farmers Association	4/09/95	Financial Fraud (problem loans)	related party loans	NT\$800 million
Min-hsiung Farmer's Assoc.	23/09/95	Financial Fraud (problem loans)	Accounting statutes	NT\$200 million
His-hu Farmers' Association	27/09/95	Financial Fraud (problem loans)	anti-corruption	NT\$150 million

(Source: Lee, 1998, Chou 2000, and the Central Depository Corporation)

government intervention. Thus, majority shareholders and managers were forced to pay for their mismanagement both in financial terms as well as in stiff fines and jail sentences imposed by the central government.

The most profound effect of the cross-straits crisis was that it demonstrated Taiwan's vulnerable geostrategic position, which further emphasized in the mind of Taiwan's regulators that the greatest threat to Taiwan's domestic financial stability was its increasing dependence upon China's vast markets. The "nightmare" scenario that most preoccupied Taiwan's regulators was that at sometime in the future, China could use Taiwan's investments in the mainland as a way of "holding up" Taiwan diplomatically. As a result, the Lee tung-hui government believed that its primary responsibility was to reduce Taiwan's vulnerability to the markets of mainland China and to protect domestic financial markets from any future diplomatically induced economic disturbances. Insulating domestic markets was not costless however, and the priority of protecting Taiwan's financial markets meant that reforms that targeted political corruption, nominee accounts, and more fundamental institutional reform would have to be postponed.

In order to reduce Taiwan's vulnerability to external shocks, the government attempted with little success, to reduce the magnitude of investment flows and to intensify regulatory surveillance over the flows that were approved by the government. However, instead of delegating the central government's powers to independent agencies, Lee tung-hui sought to concentrate regulatory powers within the Executive Yuan, and in 1994, Lee announced the "go slow, be patient" policy which imposed a new set of constraints upon outward investment flows to China. The new policy sought to prohibit any participation in the infrastructure sector on the mainland and to restrict investment in high tech industries that would be largely irreversible. The new policy also subjected investments proposals of over \$50 million to a case-by-case basis approval process.

The second component of Lee's overall policy was to employ the Mainland Affairs Commission (MAC) and the Straights Exchange Foundation (SEF) to monitor the outward investment flows more carefully. The government also established four "stabilization" funds that would bail out the real estate and stock market in case of externally induced shocks. Finally, Lee sought to reduce the likelihood of deposit runs upon domestic financial institutions by expanding the powers of the CDIC over the non-bank financial sector. Although the ultimate source of the corruption at the regional cooperatives and credit bureaus was political, Lee sought to increase public trust in the non-bank financial sector by increasing the number of examiners at the CDIC by 50 percent.

The distributive consequences of Lee's new policies proved to be difficult to manage, because the large business conglomerates such as Formosa Plastics, Evergreen Taiwan Semiconductors and The President business group officially obeyed the new policies but lobbied both publicly and privately for a relaxation of the policy. In order to compensate the business leaders for the restrictions imposed upon investment to China by announcing a "Go South" policy that encouraged trade with and investment in South East Asia, primarily in Indonesia, Malaysia and Thailand. South East Asian investment did increase from US\$2 billion to \$4 billion from 1994 to 1999, but this did little to stem the flow of money to China. Hence, instead of stifling investments to the mainland, outward investment flows to China actually increased in 1996 to \$30 million and rose to \$35 billion by 1999.

Although the government's policies did not reduce Taiwan's exposure to the mainland, the new regulatory measures designed to minimize the domestic financial fallout from external shocks proved instrumental in mitigating the overall effects of the Asian financial crisis upon Taiwan. Ironically, because the Asian financial crisis occurred immediately after the cross straits crisis, Taiwanese regulators were by this time well practiced at managing crisis. As a result of their continuous practice at

crisis management, Taiwan's regulators had been forced to adopt a forward-looking approach to crisis management and so dealing with the financial fallout of an externally generated crisis had now become standard operating procedures. Even the distributional struggle between government regulators and the Taiwanese corporations, over enforcement of restrictions upon investments to the mainland, had forced the government regulators create new institutions to monitor and investigate of the banking system. Thus, while Taiwan's regulators had not predicted the precise timing of the crisis and were as surprised as other public officials throughout Asia, Taiwan's response to the crisis suggests that public regulators anticipated yet another crisis at some future date.

At the beginning of the Asian financial crisis, the Central Bank of China tried to maintain a stable exchange rate of NT\$28.6 per US dollar. But as the crisis gained momentum by October, the central bank ceased its intervention on the 17th of October and allowed the value of the NT\$ dollar to float. By the end of 1997, the NT dollar had devalued by 14.8 percent against the dollar, by March 1998, 14.9 percent. Stock prices were actually 4 percent higher by March 1998 than in June 1997. Interest rates were only moderately affected by the crisis and were not used to support the NT dollar.

Although Taiwan's macroeconomic and industrial policy were superior to the countries beset by financial crisis, the fact that Taiwan engaged in \$29 billion with the ASEAN countries, which represented 13% of Taiwan's exports in 1997, created a "trade channel" through which the losses of the other Asian economies could effect Taiwan. As a consequence, the CBC was forced to expend \$5 billion to defend the par value of the \$NT in early July 1997. Due to speculative pressures, the \$NT depreciated 8 percent, from \$NT 30.5 per dollar, which was the lowest level in a decade. Between July and October 1997, the CBC spent a total of \$7 billion to keep the \$NT at 28.6 to \$1 US dollar. After the Korean won devalued, the \$NT

depreciated a further 19 percent, from \$NT 28 to a dollar to \$NT 34.5 to one dollar. In U.S. dollar terms the Taipei stock index fell 0.4 percent as compared to 42 to 75 percent that were experienced by other Asian markets. However, during the second half of 1997, the Taipei index fell by 28 percent.

The forced devaluation of the NT\$ had a sufficient effect upon Taiwan's financial markets so that many observers wondered openly if Taiwan would be the next country to experience financial crisis. However, the balance sheets of Taiwan's banks were far better managed than those within the banks of other Asian economies and Taiwanese firms were far less leveraged with debt than their Asian competitors. At the end of 1997, foreign exchange reserves were US\$83.5 billion, while public foreign debt as only US\$0.1 billion. Private sector foreign debt was US\$30 billion at the end of June 1997, but foreign assets were US\$35.5 billion, leaving the private sector in the position of an overall international net creditor.²²⁵

Most accounts of Taiwan's performance during the Asian financial crisis stress macroeconomic strength, industrial structure, and the CBC's vaunted foreign exchange reserves; all which undoubtedly helped Taiwan successfully weather the 1997 crisis. However, most authors have overlooked the regulation of banks and the differences between the management policies of Taiwanese banks and their less successful counterparts in other parts of Asia. For instance, instead of a single regulatory agency, three public institutions devoted to financial regulation have evolved in Taiwan; the BMA, the CBC, and the CDIC; as well as the various arms of the central government who can enforce the banking law. And even the KMT management culture that inspired corruption within Taiwan's major banks also instilled an extreme degree of risk averseness among Taiwan's bank managers. The same is not true of Taiwan's non-bank financial sector however, and had Taiwan's

²²⁵ Kuo and Liu, 186

commercial banks suffered from the same practices as the non-bank sector, fallout from crisis could have been much more severe, even without the large external debt.

Governance tradition of new banks came out of old banks and multinational banks and so risk profile of new banks reflected conservative corporate culture. Bank governance is also distinguished in Taiwan by the fact that only in the mid 1990s was external borrowing permitted. At the microeconomic level, small firms that can adjust quickly to alterations in global trading environment dominate Taiwan's industrial structure. Thus, in 1997, credit demand by manufacturers and construction industry actually grew by 15.4 percent and 9.1 percent respectively, which was the highest levels since 1993. Furthermore, overdue loan rates at the big three banks was significantly higher at the end of 1997, than 1996. At First Commercial bank, for instance, the overdue loan rate was 4.3 percent, while the overdue rate was 5.7 percent at Chung Hwa bank. Together the big three banks set aside NT\$ 5.2 billion to cover bad debts in the second half of 1997, and the overdue loan ratio at all banks in Taiwan actually fell in 1997 to 3.4 percent from 4 percent in 1996.

The new banks, such as Sun E. and Entie bank did belong to larger family owned conglomerates, but these banks received particular attention from the examiners at the CBC and the BMA in order to minimize the ability of firms to transfer bad assets to their cognate banks and in order to assure that banks could not improve their capital levels by transferring bad assets to associate firms. Furthermore, as a general rule, stocks are set by banks at 60 percent of their market price and at the end of 1997, loans secured by stocks accounted for only 3.7 percent of total loans for financial institutions. CBC regulations limit real estate exposure to 20 percent of a bank's portfolio, so asset volatility is not as damaging to Taiwanese banks.

Non-bank financial institutions such as bills finance companies and securities firms, which were the source of so much inflationary pressure in Thailand, were

leveraged at a level lower than the official limits in Taiwan. The financial structure of non-financial companies was also sound. The ratio of liabilities to net worth of all listed non-financial companies was only 78 percent on average in September 1997, and even if financial institutions are included the ratio of liabilities to net worth is only 145 percent. (Kuo and Liu, 186-7). The capital to asset ratio was relatively high by regional and international standards, despite rising NPLs.²²⁶

The stabilization funds and more responsible regulatory measures were thus intended to pre-empt any future diplomatically induced financial crisis. Furthermore, because Taiwan's macroeconomic and financial strength could never be taken for granted, the regulatory system that evolved after the cross straits crisis reflected a certain level of redundancy and as well as a division of labor between regulatory institutions.

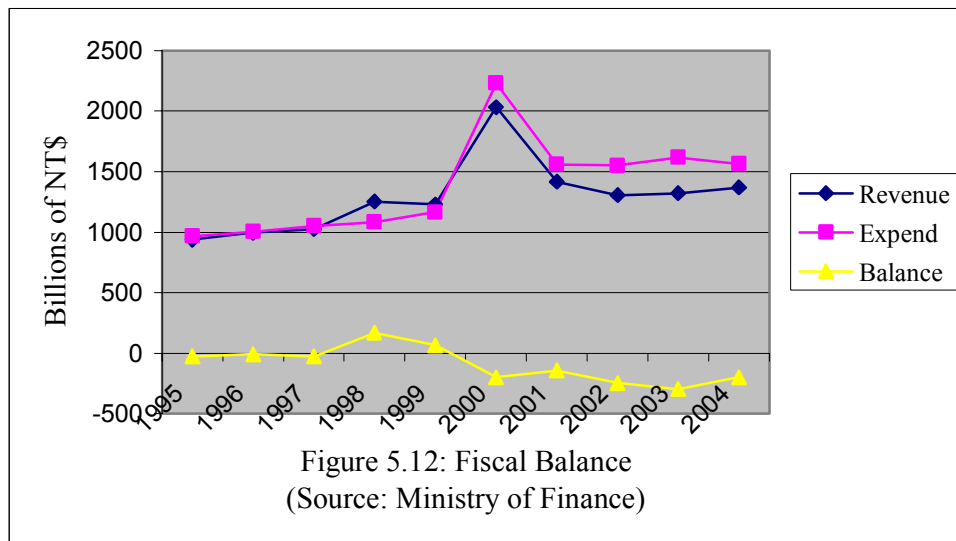
The governance relationship between banks and firms was also different in Taiwan in comparison to the Asian crisis economies. Because of government regulations, most Taiwanese banks did not belong to a holding company structure, which allowed powerful families to concentrate economic power in their hands by using family owned banks to branch out into the non-financial sectors of the economy.

Despite the moral hazard created by the stabilization funds, the spread of nominee accounts, and the attendant problem of "black gold", Taiwan's uncertainty regarding its geo-strategic position meant that financial stability would have to take precedence over the requirements of prudential regulation. Despite the moral hazard created by the stabilization funds, the spread of nominee accounts, and the attendant problem of "black gold", Taiwan's uncertainty regarding its geo-strategic position meant that financial stability would have to take precedence over the requirements of prudential regulation.

²²⁶ Kuo and Liu, 188

5.34 Discipline and Punish: Banks and the Politics of Anti-Corruption

Chen Shui-bian came to power in March 2000, after only the second direct presidential elections in Taiwan's history. Chen's administration immediately came under diplomatic pressure from mainland China, which threatened war should Chen follow-through on his campaign promise to hold a referendum on Taiwanese independence. Chen also came under domestic political pressure from the KMT, who had lost the presidency but still maintained a majority control over the Legislative Yuan and the military, as well as the administrative bureaucracy.²²⁷



As the ruling party, the DPP was forced to confront Taiwan's deteriorating fiscal position, which is depicted in Figure 5.12 above. Thus, despite the DPP's minority position in the Legislative Yuan, Chen pushed through measures designed to reinforce pre-existing anti-corruption laws and established new anti-corruption agencies. The new administration's policies were not simply motivated by financial

²²⁷ Roy, 230

prudence, but targeted the illicit financial infrastructure that supported the KMT's "black gold" network of electoral fraud and political racketeering.

Chen Shui-bian's campaign to impose new regulatory constraints upon Taiwan's financial sector were frustrated by the extension Taiwan's banks to mainland China, which put them beyond government controls. Domestically however, Chen's administration required many of Taiwan's weaker domestic banks to re-capitalize, and the Ministry of Justice even issued arrest warrants against several of Taiwan's most prominent bankers. The new regulations and draconian enforcement measures had a dampening effect upon the overall supply of credit in 2002-2003, but the new measures compelled banks to reduce their level overdue loans and forced many banking industry executives to accept personal responsibility for the financial mismanagement of the 1990s.

By the time Chen Shui-bian ascended to the office of President in June 2000, Taiwan's external economic environment had deteriorated beyond the immediate after affects of the Asian financial crisis. By 2000, financial crisis and corporate governance failure had extended to American markets, and Japan still showed little sign of economic or financial recovery. Because of the bursting of the American high tech "bubble" in particular, Taiwan's industrial exports collapsed and several associated industries suddenly faced an uncertain future. Furthermore, Taiwan's Asian trading partners were in the midst of post-crisis reforms and even the strongest of the "emerging markets, Russia, Brazil and Argentina, experienced successive financial crises between 1999 and 2001, creating a decidedly negative sentiment among multinational bankers and global investors. The global recession was reflected in the compression of Taiwan's trade surplus, persistent budget deficits, and the rise in unemployment level to 4.5 percent. Domestic financial markets responded predictably, and so after just one year of Chen Shui-bian's administration, the Taipei

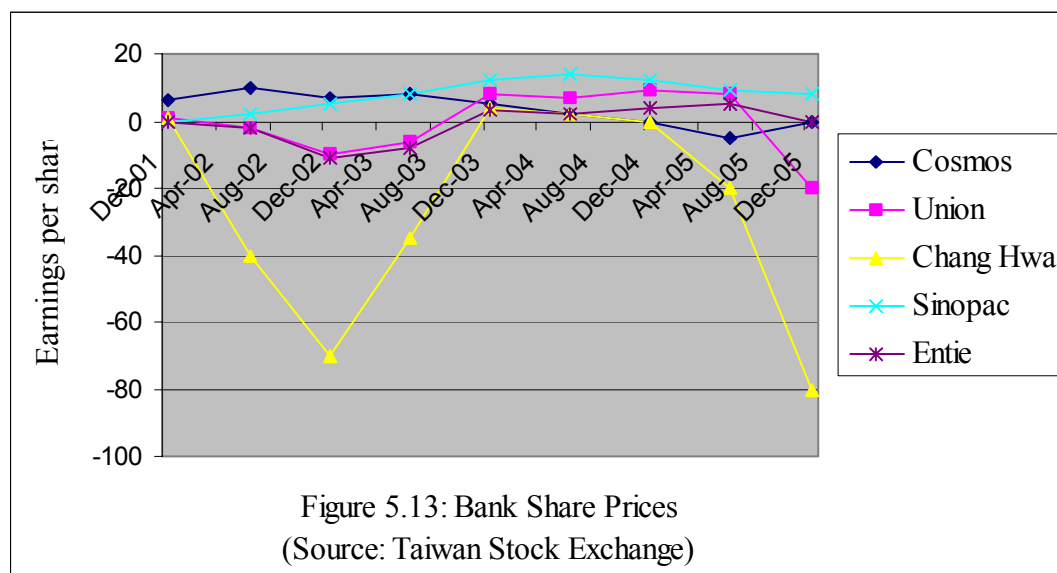
Index had lost half of its overall value and Taiwan had to face the most severe recession that had been recorded in nearly a quarter century.

To add to Chen Shui-bian's problems, the DPP had only secured 39.3 percent of the presidential vote and held only one-third of the seats in the Legislative Yuan. Hence, the KMT was able to postpone any financial reforms that disadvantaged KMT-associated financial institutions and corporate assets. The inability of any one party to dominate both the presidency and the legislature led to pre-election and post-election coordination between the various parties. The KMT and PFP formed a "pan Blue" coalition to counter the "pan-Green" coalition between the DPP and the TSU.²²⁸ The DPP improved its position within the Legislative Yuan in December 2001, by increasing the number of its seats from 66 to 87, while the potential ally, the TSU won 13 seats. The KMT was the biggest loser, going from 110 seats to 68, but Soong's PFP gained 46 seats. Together, the "pan-Blue" bloc controlled 114 seats, which enabled them to veto the power of the DPP's plurality in the Legislative Yuan.²²⁹

Two main challenges, beyond the always precarious cross straits relations, was black gold and the deteriorating economic condition, which included an ever-weakening financial system. The problems caused by the banking sector's deteriorating circumstances can be seen in the depressed share prices of Taiwan's financial sector, which is depicted in Figure 5.13.

²²⁸ Jih-wen Lin, 3-5

²²⁹ Roy, 235



To address the weaknesses and to relieve some of the budgetary deficits, which by 2002 had reached US\$ 8 billion (NT\$291 billion), the government planned to finally privatize shares in the largest of Taiwan's publicly owned banks. Taiwan now had a total of 52 banks and over 300 credit cooperatives in 2002, and a reported NPLs of NT\$1.03 trillion, or US\$30 billion (Finance Asia, Jackie Horne). However, actual NPLs were probably twice the officially stated amount. At the end of 2002, NPLs were reported at 8.86 percent but unofficial figures placed total NPLs at 11.47 percent of total loans. The underestimation of NPLs occurred are for two reasons. The first is that the pre-2003 reporting rules allowed banks to designate loans as non performing a full 6 months after the last payment, while international standards designated loans as non-performing after just 3 months of non-payment.

To redress the NPL problem, the government announced "target 258" provision that required all banks must reduced their NPLs to less than 5 percent of their total loan portfolios and reach the 8 percent capital ratio by early 2004. The authorities have thus issued an implied threat that any banks that fail to meet the target 258 measures will be forced to merge with stronger rivals. Prior to the government policy, in December 2001, Taiwanese banks reported an average CAR

level of domestic banks was 10.4 percent. These reported figures were probably over-estimated for many banks.²³⁰ Estimates of bank's NPL figures for the end of 2001 were 11.74 percent, which fell to 8.86 percent by the end of 2002. However, in 2002 huge NPL write-offs reached US\$11.88 billion according to government estimates. Banks also increased their tier-2 capital by boosting their subordinated debt. As a result of target 258 policies, the average CAR ratio dropped an average of 3 to 4 percentage points. In 2002, it is estimated that banks offloaded up to NT\$185 billion (US\$ 5.3 billion) in bad debts, while a similar amount has been deleted from the balance sheets of domestic banks in 2003.

On August 2003, two former managers of Chang Hwa Hsinhsing branch, Lin Ching-tien and a former manager of Pan Asia's Southern Kaohsiung branch, Lin Yu-fu, were taken into custody for their involvement in the Chang Hwa bank loan scandal. A third man, Lee Kun-hu, the nephew of former Chang Hwa bank chairman M.H. Tsai. The two branch managers bypass the proper procedure for securing a NT\$810 million loan for Fu You Group. The Fu You development project never got under way and payments on the loan were irregular.²³¹ The Ministry of Finance banned a high profile visit by bankers to China as part of a crackdown on financial irregularities. The crackdown focused on three banks and six listed companies. (Taiwan News, September 14, 2000) Companies in trouble include Hung Kuo conglomerate, Tuntex, and Ever Fortune Construction, who have had to downsize or deal with liquidity problems and accusations of improper financial transactions. (The China Post). Stock market eroded due to government crackdown, but was not sufficient to cause government intervention through four stabilizations funds.

²³⁰ Beyond the 6 month rule for designating a loan as non-performing, Taiwanese banks underestimate the true levels of NPLs because they report NPLs net the expected recovery which underestimates the true level because collateral disposals have often failed to realize valuation prices.

²³¹ The China Post

5.4 Conclusion

Chien Shui-bian was re-elected to the Presidency on May 20th, 2004. Chien's re-election was surrounded by controversy and drama, and Chien was even shot in a failed assassination three days prior to the election. Following his re-election, Chien made further moves to separate Taiwan from the PCR by renouncing for the first time in Taiwan's history that the ROC no longer represented the legitimate government of both Chinas. By February of 2006, Chien even abolished the National Unification Council as further evidence of his intention to test the PCR's resolve regarding Taiwanese independence.

Chen's new diplomatic strategy has been severely undermined by recent allegations regarding his own financial dealings as well as those of his wife and confidants. Financial corruption has again taken center stage in Taiwan and has practically crippled the Chen government. Finance and national security have come together yet again to threaten Taiwan's stability and that of its financial markets.

Taiwan's regulatory system will have to adapt to Taiwan's still perilous relationship with mainland China and Taiwan's divisive internal politics. As Taiwan's financial sector grows, the government's diplomatic freedom of action will be constrained by its burgeoning financial interests in mainland China and the greater Asia region. However, the growth of native Taiwanese financial interests will also push the government to act more like an independent republic and less like a legally unrecognized trading state. Consequently, as the PRC and Taiwan struggle over the ultimate fate of Taiwan, the financial struggles within Taiwan will undoubtedly play a central role in determining the country's future.

Chapter 6

Theoretical and Empirical Retrospective

6.1 Introduction

The central argument of my thesis is that the contract theoretic model presented in chapter two can explain instances of regulatory discipline as well as cases of regulatory failure. The underlying theoretical framework is based upon the insight that iniquitous distributions of the monetary and fiscal outputs of the banking sector lead to distributional conflict, which undermines the stability of the banking sector. Consequently, any theory of regulatory success or failure has to consider the distributional consequences of financial regulation upon society.

In order to fully assess the success and theoretical potential of the contract theoretic approach to distributional conflict, the current chapter is divided into two sections; the first section is a theoretical retrospective of chapters two and three, and the second section is an empirical assessment of the application of the theory contained in chapters three and four. Chapter six will then address the primary theoretical and empirical weakness of the previous chapters and will make suggestions regarding future research possibilities that could yield a more complete theory as well as a more rigorous empirical test of the claims made throughout the preceding chapters.

The theoretical claims made in chapter two and chapter three can be summarized in terms of the following four points:

Hypothesis 1) Regulatory actions have monetary and fiscal consequences; which are distributed among the taxpayers, bank managers, and the bank's minority shareholders.

Hypothesis 2) Because of the inevitable monetary and fiscal consequences of regulatory actions, the delegation of regulatory powers to an independent government agency does not eliminate the incentive for distributional conflict between the different sectors of society.

Conclusion) The solution to the regulatory contract yielded three sets of pure strategy Nash equilibria. Furthermore, there exists one subset of pure strategy Nash equilibria which Pareto dominates a second subset of equilibria, but which is Pareto non-comparable to a third set of pure strategy Nash equilibria.

Assessment) A Pareto improving (equitable) policy is feasible under very limited conditions, and in all other cases, regulatory action privileges one set of actors and discriminates against another set of social actors in terms of the monetary and fiscal consequences of regulatory policy. The model also generated four sets of empirically testable predictions

Prediction 1) In a credit boom, bank managers and minority shareholders are privileged, while taxpayers and shareholders must ultimately bear the burden of any bankruptcy costs at some future date.

Prediction 2) In a credit crunch, minority shareholders are privileged and bank managers are relatively unhurt, while the public must bear a reduction in the rate of credit expansion.

Prediction 3) Bank managers will abide by prudential regulatory standards only if the government can credibly enforce a threat of regulatory intervention, in terms of the equitable allocation of decision-making authority and in terms of the distribution of bankruptcy costs.

Prediction 4) No specific political or bureaucratic configuration, in terms of regime type, electoral rules, or legally prescribed relationship between the executive branch and the regulatory agency can fully eliminate the incentive for distributional conflict over the allocation of the costs and benefits of financial regulation.

6.2 Theoretical Critique

The positive political economy literature explains policy credibility in terms of a government's resolve to sustain an announced policy, but the notion of "resolve" remains theoretically under-analyzed. As I have argued in chapters two through five, a government's regulatory authority is a function of the more fundamental distribution of decision-making authority and the monetary and fiscal outputs of the banking sector. A credible policy must equitably reflect the interests of the social actors whose welfare will be influenced by the announced policy. Compensating the social actors who will lose as a result of newly announced policy will thus be insufficient to sustain a policy, since the compensation of losers by winners does not take into consideration the loss of decision making power regarding the *future* distribution of resources which results from the *current* social allocation of wealth and power.

Thus, costly measures designed to signal a government commitment to a reform process may not be sufficient to sustain that process in the long run, because credibility is not only predicated upon the "will to govern" but is rather a function of the underlying social order that can either support or deny the government's legitimate right to make decisions that impinge upon the welfare and future actions of the relevant social actors. Hence, unless the instrumental definition of credibility is supplemented by an understanding how policies effect the dominant social order, the literature will continue to underestimate the extent to which disadvantaged groups have an incentive to either change or overthrow the new social order that is implied by an economic reform program.

Furthermore, the bulk of the political economy literature continues to ignore the possibility that an ideal social distribution of resources and decision making power may not be feasible, and we may instead be forced to choose between Pareto

non-comparable outcomes. If a government must make a choice between Pareto non-comparable outcomes, a stable policy trajectory may be impossible to assure in the long run, as disadvantaged groups seek to impose an order that would disadvantage rival groups that enjoy a dominant or privileged position in the current period. The lack of a clear Pareto optimal policy could thus render impossible the goal of achieving a policy trajectory that is credible in the long-term.

The difficulty of achieving a Pareto optimal policy raises potentially devastating problems for the claim that a stable and efficient policy outcome can be achieved through the institutional delegation of regulatory powers to an independent government agency. In other words, the delegation of the regulatory function to an independent government agency may neither achieve a stable nor an efficient policy trajectory. Furthermore, the existence of Pareto non-comparable equilibria in the overall solution set would mean that distributional decisions are left unresolved by the delegation of regulatory power. Given that such ultimate distributive decisions are beyond the legislative and constitutionally mandated authority of government agencies, the ultimate distributive decisions would have to be performed by a higher governmental authority.

Hence, executive intervention may thus be necessary in order to determine which of the many Pareto non-comparable outcomes will ultimately be selected as the official policy. Institutional delegation, under these circumstances, would not solve the problem of distributional conflict, which would have to be resolved by another branch of government (i.e. the dominant party, the legislature, the judiciary, or executive branch of government).

Instead of providing a convincing demonstration of all of the conclusions referred to in the theoretical section above, the model presented in Chapter two should be viewed as a “first cut,” or a preliminary attempt to outline a set of theoretical issues and conclusions that can be achieved by a more fully specified model. In retrospect,

the model presented in chapter two fails to fully exposit the theoretical claims of chapter two for four distinct reasons:

Problem 1) The regulatory contract does not incorporate a distribution of risk between bank managers and the public regulator, nor does the model incorporate the feature of asymmetric information, which would be required in order to engage in any meaningful discussion regarding moral hazard.

Problem 2) The regulatory contract is not dynamic and so any interpretation regarding future distributive decisions is technically impossible to support.

Problem 3) The model does not adequately specify the liability side of the bank's balance sheet, with regards to depositors and with regards to the effects of reserves upon the transformation of liquidity from deposits to assets, which would render a discussion of the monetary consequences of regulatory actions impossible.

Problem 4) The model is indeterminate regarding the ultimate relationship between the organization of government and the delegation of regulatory power. Even if the theoretical goal of the model is to demonstrate that there is no optimal relationship between the other branches of government and the public regulator, this has to be incorporated in the model explicitly and not simply assumed as a general implication of the model. We can now consider the four sets of theoretical objections to the contract theoretic model presented in chapter two in detail.

Risk Distribution and Asymmetric Information

A primary weakness of the regulatory contract outlined in chapter two was that the social distribution of the costs and benefits of financial regulation occurred only at the end of the game and this distribution was not a direct result of the model's dynamics. Incorporating the distributive process more explicitly would require that the utility of all social actors be specified directly as part of the contract. A full

justification of each actor's utility function would also require that, in principle, each social actor should have a move in the game.

Hence, I have modified the game to include a move by the BM (bank manager), as well as the CB (public regulator) and the SH (shareholders). Intervention into the affairs of an insolvent bank would now imply that control of the bank's future capital-asset decisions has been transferred to the bank's shareholders, who now have a move in the game.

However, a revised regulatory would rely on the fact that the CB's utility is divided between the taxpayers and the bank's shareholders at the end of the game, which implies that the central bank is left with a net income of zero. A more realistic model would include a way of motivating the central bank. For instance, if the central bank's is paid a linear wage, we can motivate the regulator to behave in accordance with the regulatory contract regardless of the consequences for the contracting parties. However, if the regulator's utility is a state-dependent, i.e. upon the rate of credit expansion, then the public regulator would still face an incentive problem, since the benefit derived from practicing unwarranted forbearance could outweigh any deduction from the regulator's wages from allowing an insolvent bank to continue operating. Hence, modulating the mathematical characteristics of the regulator's utility function will determine the ultimate distribution of the costs and benefits of financial regulation.

The third feature that is missing from the specification of the regulatory contract is asymmetric information regarding the initial capital-asset allocation of the bank manager in the first period. The capital asset decision discussed in chapter two is also non-stochastic and thus no distribution of risk is possible between the bank manager and the public regulator. In order to engage in any meaningful discussion of moral hazard, at least one of the capital-asset combinations should involve a

probabilistic function that varies the value of the capital asset decision in the second period.

Inter-temporal Allocation of Costs and Benefits

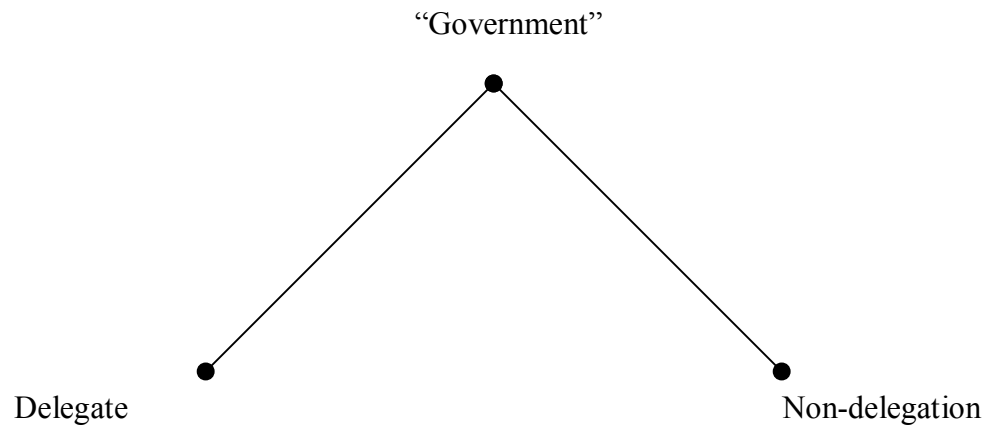
The model can be modified to include a second period in which the new owners can make allocative decisions in the case wherein the central bank has intervened in the operations of the bank. Hence the second period of asset allocation captures the possibility that the public regulator can alter the future distribution of credit to the economy. A multiple period, or infinite horizon model can be used to demonstrate the instability of equilibria in the long run. A series of decisions that are rational given the local institutional and structural constraints, but that cumulatively have a disastrous macro-outcome. Requires some form of scaling effect to be incorporated into the model.

Balance Sheet Specification

In order to account for the different states of the world predicted by the model, a complete specification of the bank's balance sheet is necessary, as well as a more explicit treatment for the effect of the bank manager's decisions upon the macro credit market. According to the credit view of monetary policy, the credit channel operates through the bank's management's decisions to modulate the bank's reserves levels, which would enable the bank to increase or decrease its deposits (liabilities) and thereby increase or decrease its loans to the public (asset portfolio). The bank's balance sheet should also be altered to include the risk of asset failure, which means that the revenue yielded by the bank's asset portfolio must vary with some well-defined probability distribution.

Institutional Specification

A more precise institutional specification can be represented in the case in which delegation occurs and a case wherein regulatory powers are wielded directly by the executive branch of government (non-delegation).



6.3 Empirical Critique

Empirically, the research design implemented in chapters four and five suffers from the methodological flaws inherent to any small sample study. Including other case studies may help, but unless the case studies become sufficiently large, the interpretations implied by the model will remain speculative. The parameters are insufficiently specified empirically and there is no way to clearly measurement of these parameters implied by the model. Large samples of banking and regulation related data are now available from the World Bank project devoted to the comparative study of regulatory systems.

According to chapters two and three, there are three primary hypothetical claims that are generated by the formal model:

H (1): Each regulatory action has distinct and measurable monetary and fiscal consequences.

H (2): There is no specific regime type or government-regulator relationship that has a measurable effect upon the incidence of bank crisis

H (3) Bank managers abide by prudential regulatory standards only if the central bank equitably allocates bankruptcy costs and managerial liability.

The problems associated with testing this hypothesis empirically are many. First, “monetary and fiscal consequences” refers to the consequences of regulatory actions upon monetary policy, as well as the costs and benefits borne by the taxpayers, bank managers (in terms of pay) and shareholders (returns on investment). Hence, not only are the terms “monetary and fiscal consequences” vague and somewhat inaccurate, but the various meanings captured by these terms need to be analyzed separately

Furthermore, fiscal consequences may be readily measurable in terms of the effect of regulatory-bank events upon government debt as well as per capita contributions to the debt that is generated during a financial crisis. However, the effects of regulatory actions upon bank managers’ pay and upon shareholder returns maybe somewhat more difficult to measure. Although bank manager data may exist, it may be highly confidential and publicly unavailable, while the return on investment data should be readily available from each country’s stock exchange.

The second hypothesis maybe even more controversial as it would contradict the insights of the literature that is devoted to banking regulation as well as at least the spirit of the central bank independence literature.

As was argued in chapter three, Singapore, Taiwan, and Hong Kong contain highly competent regulatory agencies that are not independent of the central authorities, although countries that have experienced banking crises repeatedly contain both independent as well as non-independent regulatory agencies. Nor is

regime type of importance to the incidence of banking crisis or regulatory failure, since democracies seem to be just as prone to regulatory failure as non-democracies. Political instability and regime change seems to be more important, as political unrest would influence the efficacy of regulatory agencies by making the future less certain with regards to a government's policies.

A more rigorous test could employ data from all countries that release such data, which is available in the World Bank banking regulation data set. This data set suffers from its own problems however, such as a lack of a common definition for many regulatory categories as well as inconsistent regulatory laws across countries, which makes it very difficult to measure the independent causal effects of a particular rule or set of institutions.

6.4 Conclusion

The model presented in chapter two and the empirical investigations included in chapters four and five should be considered a first step in a broader research project. A more precise model can now be constructed to include various institutional and economic features that were not included in the model due to time and resource constraints. However, various refinements, both theoretical and empirical, can now be added to more fully explore the main hypotheses presented in chapter two and three. Finally, an open economy component can be developed in order to investigate the relationship between distributional conflict within the domestic credit market and the sustainability of various exchange rate regimes.

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